



The Institute for Urban Economics

**The Current Status and Potential for Development
of the Long-Term Mortgage Lending System
in Ukraine**

Analytical Report

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1. Introduction and executive summary

The US Agency for International Development (USAID) is now exploring the possibility of involvement of the Ukraine commercial banking sector into the mortgage finance development. The USAID contracted out this research to the Institute for Urban Economics (IUE, Moscow), findings and results of which are stated in this analytical report. The research objective was to investigate current legal and economic preconditions for the development of the nation-wide long-term mortgage finance development.

In October 2002, the IUE sent a team of three consultants to Kiev for a two-week field research of the legal feasibility of mortgage lending development designed to study the situation on the housing and commercial real property markets in order to determine the potential demand for mortgage services and identify most common difficulties and challenges that governmental authorities, banks, real brokers and other participants of the real estate market usually meet in the area of real estate finance and mortgage lending.

1.1. *Housing finance and mortgage lending in Ukraine*

Over the last five years the Ukraine policy of retail housing finance witnessed serious changes. The role of the government in housing finance radically dropped: today the government continues subsidizing just three population groups: young families, servicemen and Chernobyl victims. The all three programs are mostly designed to provide newly constructed housing to clients either free of charge or by extending long-term interest-free or reduced-interest loans.

Presently the government is responsible for mere 5 percent of total resources invested into residential construction and housing finance programs which are now financed mostly by private investors and retail clients and to a lesser extent by banks.

Most part of new housing is constructed at the expense of individual savings that are attracted either by concluding investment contracts with households or by advance payment of the full cost of housing while it is still under construction.

Banks still play a minor role in financing housing needs of their retail clients. According to statistics provided by leading banks (*Oschadbank, Ukrsotsbank, Aval Bank, Privat Bank, Arkada Bank, Forum Bank* and several others) mortgage loans account for mere 1-3 percent of their credit portfolio.

The low motivation of the banking sector to provide mortgage services is caused by such factors as the deficit of long-term resources, legislative gap, high credit risks, underwriting difficulties, low rate of return from mortgage operations, etc.



Still, banks o demonstrate the growing interest towards retail businesses including mortgage finance. Nowadays many Ukrainian largest banks already offer mortgage services to their retail clients in a limited scale.

So, today Ukraine has necessary preconditions for the successful development of residential mortgage lending. They are:

- The lack of adequate and reliable long-term financial instruments strenthened the banks' motivation to provide mortgage services;
- The growing demand for mortgage loans on the retail housing market;
- The growth in household incomes;
- The progress in the development of mortgage legislation, and several others

Today banks are ready to help their clients in improvement of their living conditions by offering the following services:

- extending loans for co-finance of housing construction projects;
- extending loans for the purchase of housing on the primary or secondary market;
- extending loans for housing renovation purposes.

The first type of services holds the lead.

All these loan products have much in common: use of non-standard underwriting methods; most loans are denominated in U. S. dollars; the repayment period does not exceed 5 years; obligatory insurance of mortgaged property; interest rates varying between 14-18 percent per annum for USD loans and 20-26 percent for UAH loans; and LTV 65-70 percent.

One of the main factors capable to provoke the extension of the mortgage market operations is the attraction of long-term resources for mortgage purposes. To achieve this goal, particular efforts should be taken in such areas as the development and practical use of mortgage extension and servicing standards, and the professional training of banking personnel in the use of them. As a consequence, this will create a favorable environment for the development of the secondary mortgage market and the market for mortgage securities.

1.2. *Legislative environment*

The mortgage legislation and, in particular, the housing mortgage legislation, was a specific focus of the team's investigations, the outcomes of which are stated in this report.

The research performed by the team has revealed, or to be exact, has verified the validity of the already formulated conclusion that Ukrainian laws and regulations governing the housing market and banking sector operations have many deficiencies and ambiguities.

It is also worthy to note that up till now neither the business community, nor the public and governmental authorities have succeeded in suggesting proper approaches that should be reflected in this legislation.

The current status of the mortgage legislation in fact serves as a major disincentive for the successful development of the mortgage lending business in the country. The most important factors in this respect are:

- The failure to update the Civil Code leaves the whole legislative system without the basis which traditionally is treated by continental law countries as a backbone law;
- There is no consistency between the effective Civil Code and laws *On Pledge, On Enforcement Procedures, On Bankruptcy* and several others; due to these inconsistencies the foreclosure and reimbursement procedures may be delayed for one or even two years;
- The current rules of title and encumbrances registration are irregular (land rights and rights to buildings and structure are registered separately) and fail to guarantee the proper observance of rights and interests of owners (title clearness) and mortgagees;
- The civil and bank laws fail to provide strong incentives for the wider use of various advanced financial instruments (say, loans with floating interest rate).

Of particular note is the Ukrainian all-national system of computer-based registration of property alienation limitations. This progressive system should be without fail incorporated into the future title registration system which is still not developed.

The proposed draft laws and regulations need certain correction:

- Weak coordination of law-making efforts results in inconsistency of the revised version of the Civil Code and the proposed mortgage and registration laws;
- A well-designed new version of the Civil Code still require certain correction of articles dealing with mortgage finance issues, for example, the article regulating the priority of creditors' rights and liens, and the article providing for the title registration;
- The proposed mortgage law is well drafted but it still fails to identify specific features of housing and land mortgage;
- The title registration system is still suffering from conceptual (what is to be registered, how and where) and institutional (who will be the "chief" registrar) disagreements;
- Low importance is given to the need to improve them proposed laws *On Enforcement Procedures, On Bankruptcy* and several others which are of no less importance than the mortgage law;
- The importance of improvement of the effective law on taxation of housing finance and mortgage lending operations is not well understood.



1.3. The outlook for mortgage lending development

The situation on the Ukrainian mortgage lending market is now subject to both restricting and favorable factors.

The major market restraints are:

- Inadequacy of the effective legislation;
- Failure to create the land market;
- Low effective demand for retail loans
- Banks' lack of long term resources
- High price of financial resources at the domestic finance market
- Lack of the necessary infrastructure on the loan market; failure to create the system of borrower's life and labor insurance;
- Lack of domestic and outside investors;
- Failure to design an all-inclusive national program of mortgage lending development

The Ukrainian finance market does have a housing mortgage segment but it is very small. Its growth may be encouraged only by qualitative changes in the existing policies and practices of home purchase and construction finance and revision of laws and regulations governing them. The nation-wide system of mortgage finance should be based on unified standards covering the performance of all, current and future, market participants. Today, this market is still lacking institutional elements important for the successful development of mortgage lending, such as mortgage insurance services and institutional investors.

The major market advantages advocating the possibility of the rapid growth of the housing mortgage market are:

- The housing market is demonstrating a stable rising tendency;
- There are banks that have already gained an experience in retail mortgage lending and are now interested in extension of this business;
- Both professional market participants and their retail clients understand well the urgent need to develop the mortgage lending market in the country;
- The government is also strongly interested in the fast development of mortgage finance and other related industries.

The registered drop in cost efficiency of other investments also gives a strong impetus to the extension of operations on the real estate market by all its participants. The growing amount of bank deposits as well as the growing liquidity may serve as additional indicators of positive changes.

By far very important is the establishment of the National Mortgage Association in Ukraine which is expected to suggest and support the advancement of various practical



decisions capable to create the efficient system of mortgage lending incentives and regulators. There is ample evidence that the Association will be able to play this role.

The stable demand for housing property, in general, and mortgage loans, in particular, may be also treated as factors motivating the fast development of the housing mortgage market. The country witnesses a slow but stable growth of the middle class – households with monthly income varying from USD400 to 800 that are viewed as a main user of mortgage loans. According to both pessimistic and optimistic estimates, the expected capacity of the mortgage market in 2002-2003 will be USD15-30 millions, and it may even further grow if the national economic and political environment is stable.

The housing mortgage lending development is a multiphase process including the development of appropriate laws and regulations, development of the primary market for mortgage loans, and creation of prerequisites for the secondary mortgage market development, testing mechanisms for issuance and placement of mortgage securities, etc.

Nowadays, Ukraine has rather strong incentives for starting all-out efforts on securing credit institutions and their partners with adequate mortgage law, regulations and procedures designed to facilitate the extension of mortgage loans to retail clients. This report suggests specific formulas for estimating the mortgage loan affordability for various income groups of population. By applying these formulas, it is possible to see that despite of the low paying capacity there are population groups that still are capable to afford repayment of mortgage loans on market terms and conditions, and the size of these groups is sufficient to start pilot programs on introduction of advanced lending policies and practices (5-6 thousand a year) that will help concerned governmental and commercial structures to develop necessary mortgage lending mechanisms and instruments.



2. Analysis of Real Estate Markets in the Ukraine

2.1. Overview

The Ukrainian real estate market, which to a large extent is a mirror of the macroeconomic situation in the country, is undergoing a development stage. The negative factors characterizing its development include a decline in the total investment for real estate in the past 10 years and, importantly, a low level of institutional development of the primary and secondary markets, lack of essential market infrastructure, and a broad qualitative and quantitative gap between the major economic centers, first of all Kiev, and other regions. This gap, however, is no bigger than the differences in the general level of economic development across the country.

Nevertheless, after the reduction of the 90-ies, in the past three years the real estate market stabilized and began a gradual growth. This is particularly true of the secondary market, which has substantially increased its share during this time.

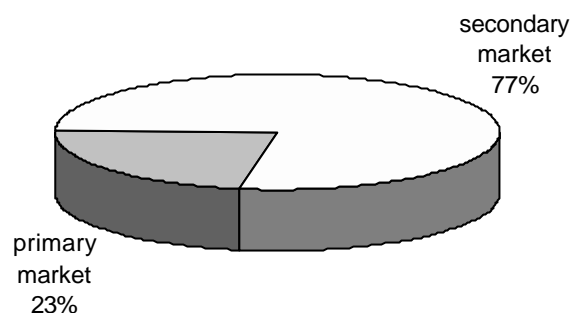
Averaging of the estimates obtained from different sources, gives the total turnover in the primary and secondary markets in the Ukraine (for residential and commercial real estate) of \$ 3.5 billion in 2001, of which about 2.7 billion represent the secondary market. The 2002 forecast is about the same. However, residential real estate constitutes about 50-60 percent of the total market, down from 60-65 percent in 1999-2000.

The long crisis in the construction sector which has reached its peak in the second half of the 90-ies drove up the share of existing properties of both residential and commercial use, i.e. the share of the secondary market. By the present, the largest regional secondary of residential real estate has formed in Kiev: its volume is estimated at about 15 percent of the total secondary real estate market in the Ukraine.



Figure 1

Estimated Primary and Secondary Markets for Residential and Commercial Real Estate in the Ukraine



In the past years, the existing housing stock grew slower, evidently as a result of lower rates of housing construction against the background of the flat or growing trend of withdrawals for the dilapidated housing stock (see Table). However, the market increased in physical terms as over 5 million apartments and single-family houses has been privatized since 1993.

Table 2

Housing Stock in Ukraine

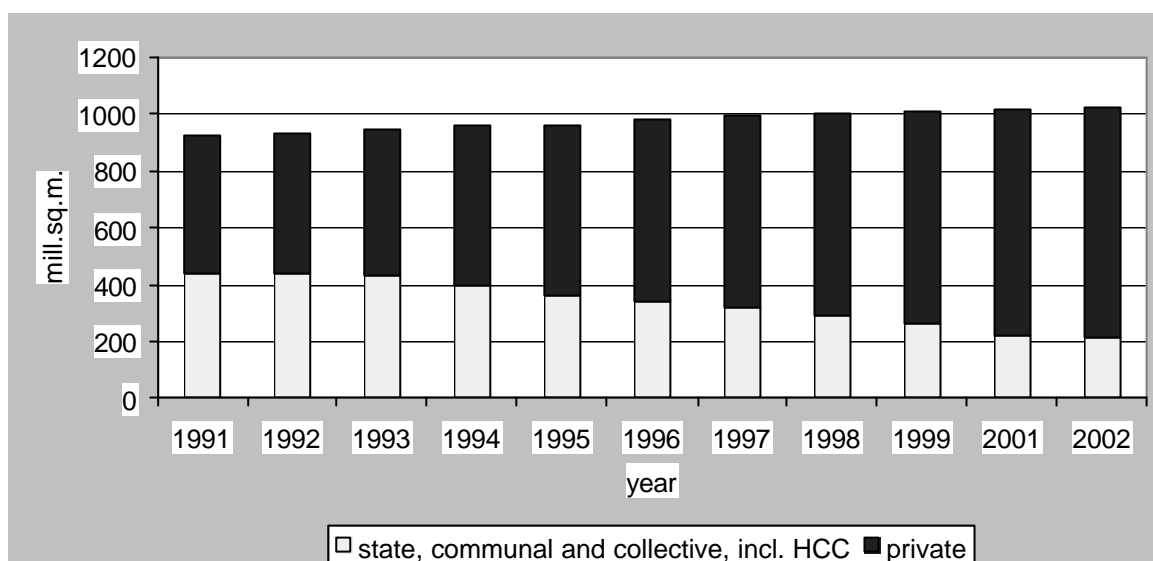
(year beginning, mill.sq.m. of total area)

Year	Total housing stock	Including:		Average per person, sq.m.
		State, communal and collective stock (incl. housing construction cooperatives)	Private stock	
1985	833.6	375.3	458.3	16.3
1991	922.1	436.4	485.7	17.8
1996	978.3	341.3	637.0	19.2
1997	995.2	317.7	677.5	19.7
1998	1002.6	292.0	710.6	20.0
1999	1008.4	264.4	744.0	20.2
2001	1015.0	221.8	793.2	20.7
2002	1026.1	215.1	811.0	21.0

Source: "Housing Stock in the Ukraine", State Statistics Committee of the Ukraine, 2002

Figure 3

Housing Stock in the Ukraine, by Ownership Form



Source: "Housing Stock in the Ukraine", State Statistics Committee of the Ukraine, 2002

A similar picture is observed on the markets for other types of real estate, including land. About 12 million Ukrainians have privatized their land plots for the total area of over 3 million hectares. Also, over 60 thousand enterprises were privatized or corporatized, in which real estate constitutes a lion's share of the total value. Undoubtedly, all these processes promoted growth of the real estate market. Moreover, the high percentage of privately-owned housing may become a strongly positive factor promoting a broad development of residential mortgage lending in the future.

Despite the expansion of the real estate market, the spectrum of services and transactions is rather limited. The key types of business on the primary market is, naturally, investment in construction projects, and on the secondary market – investment in rehabilitation and reconstruction, along with broker services, property appraisal (primarily with the use of cost-based methods), and property insurance. Lending activity is reduced to loans against the collateral of existing properties; bank financing of construction projects is rare and highly selective.

However, one should keep in mind that property appraisal is typically performed by staff experts of the investor or lender, interested in the appraised value, while insurance involves the participation of affiliates or other "related" companies, reducing to a minimum the real significance of both lines of business. There is practically no demand for real financial and economic consulting, co insurance of financial and credit risks, and securitization on the real estate markets is still at the initial phase of the debates. Residential mortgage lending and construction lending are also going through the initial phase of their development.

Summing up, one may conclude that despite the formal presence of many attributes of a market infrastructure, from the viewpoint of institutional diversity and efficiency real



estate markets in Kiev and major regional centers, to say nothing of the periphery, are in their infancy.

2.2. Residential Real Estate

2.2.1. Market Supply

Along with all other countries of the CIS, Ukraine saw a long and deep crisis of its construction sector throughout the 90-ies. The primary market suffered from substantial decreases in the volume of new construction up to 1999. the one exception was Kiev, where starting in 1996 the volume of new construction has grown on the average by 15-25 percent annually.

Starting in 1999, the volume of new housing grew steadily (see Table). In some regions the level of housing construction achieved became a strong impediment to the realtor's business on the secondary market. Nevertheless, the indicators declared in the official governmental document, *Development Forecast for Housing Construction in 2000-2004*, have not been attained. The main reason of the failure to meet the benchmarks established by the Government was the insufficient, as compared to the plan, off-budget and budget finance of the construction sector. Evidently, plans for the current year will not be fulfilled, as a little over 2 million square meters of new housing was constructed in the first half of 2002. This, however, amounts to 103 percent of the 2001 level.¹

Table 4

Dynamics of Housing Construction in the Ukraine in 1991-2001

(thou.sq.m.)

¹ Data of the *Derzhbud* of the Ukraine.

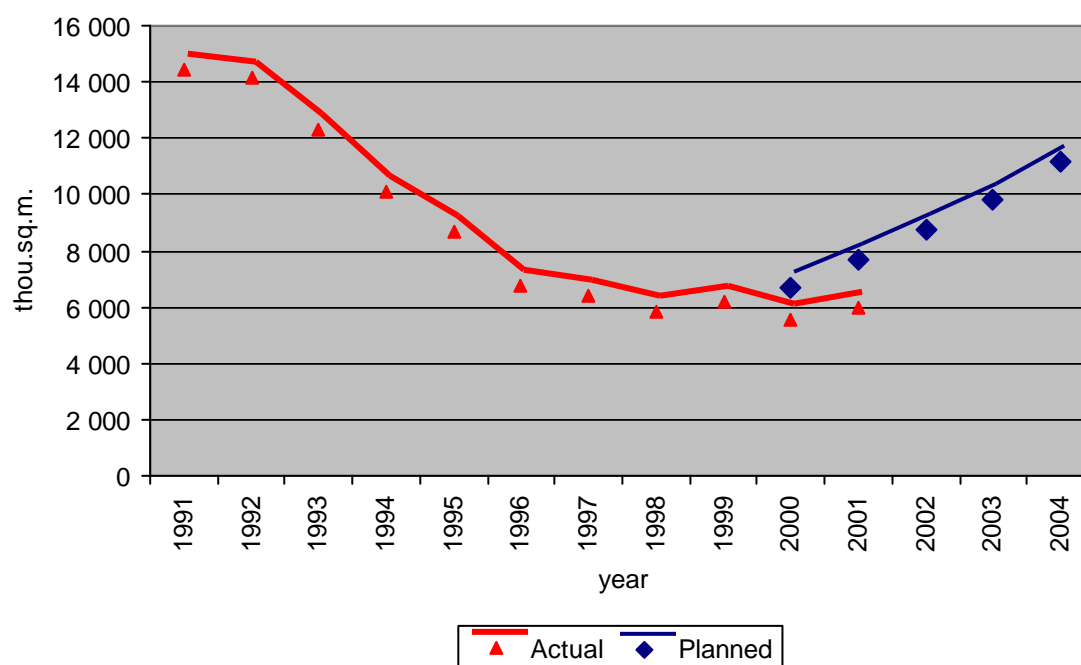


	years							
	1991	1995	1996	1997	1998	1999	2000	2001
Total by enterprises and organizations of all ownership forms	14453	8663	6754	6369	5855	6152	5558	5939
% to previous year	82.8	85.8	77.9	94.3	91.9	105.1	90.4	106.8
Percentage of total, %	100	100	100	100	100	100	100	100
including:								
state and communal property	8074	3021	1720	1297	1148	1244	926.2	1192
Percentage of total, %	55.9	34.9	25.5	20.4	19.6	20.2	16.7	20.1
collective property	2297.4	1741	1543	1536	1372	1551	1238	1235
Percentage of total, %	15.9	20.1	22.8	24.1	23.4	25.2	22.3	20.8
private property	4081.7	3893	3485	3503	3322	3333	3386	3488
Percentage of total, %	28.2	44.9	51.6	55	56.8	54.2	60.9	58.7
property of international organizations and foreign companies	-	7.2	5.7	32.5	13.5	23.9	7.8	22.7
Percentage of total, %	-	0.1	0.1	0.5	0.2	0.4	0.1	0.4

Source: State Statistics Committee of the Ukraine, 2002

Figure 5

Dynamics of Actual and Planned Housing Construction in the Ukraine in 1991-2004



Source: State Statistics Committee of the Ukraine, 2002

Taken in itself, the incomplete fulfillment of the governmental program of housing construction is not a strongly negative characteristic of the current situation. After all, how much housing may and should be built given the current balance of demand and supply is determined by market forces. Of greater concern is the government's continued reliance on budget sources and sources closely related to it for housing construction finance (direct investment, subsidized loans, etc, as will be discussed in greater detail in the next section).

As a result, the government becomes a hostage to its own policy, which has a pronounced social orientation but which is unlikely to be realized for evident lack of budget resources either now or in the near term. However, the issue of the incorrectly formulated policy for stimulating the construction complex (the government is almost always a less efficient owner and manager of resources as compared to private businesses) is outside the scope of this research. The discussion and identification of alternative approaches to stimulating the construction sector is a matter of the near future. The problem is common to all transitional economies.

Regretfully, the task is further complicated by the acute shortage of both budget and off-budget sources of construction finance. The table and chart below demonstrate that the dynamics of housing construction finance from the budget and off-budget finance in the past 3-4 years follows the same trend.

Table 6

Dynamics of Housing Construction in the Ukraine Using the State Budget and Other Sources, 1991-2001

(thou.sq.m.)

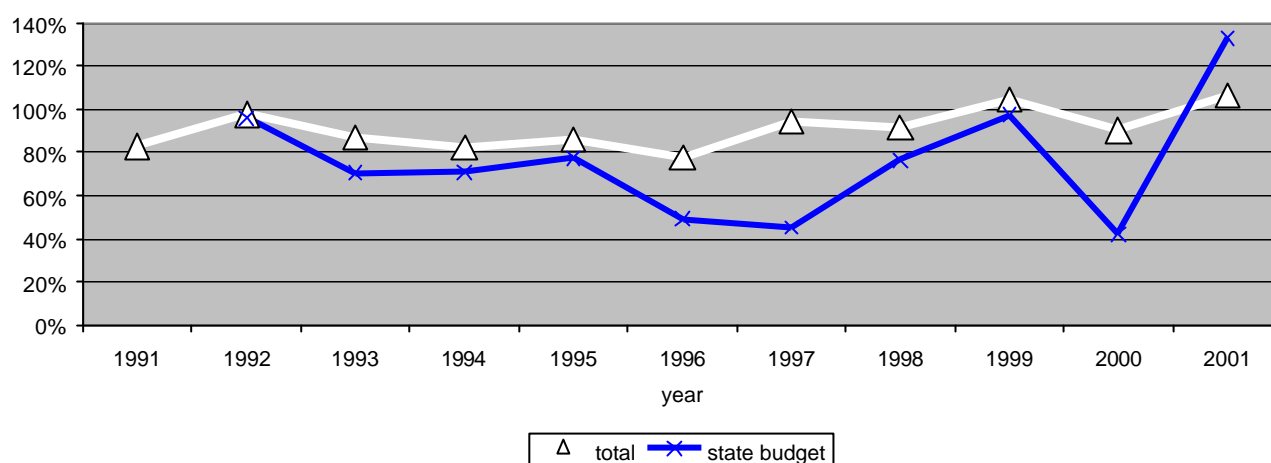
	year							
	1991	1995	1996	1997	1998	1999	2000	2001
Total by enterprises and organizations of all ownership forms	14453	8663	6754	6369	5855	6152	5558	5939
% to previous year	82,8	85,8	77,9	94,3	91,9	105,1	90,4	106,8
incl., at the expense of state budget	3244,6	1207	592,4	267,1	205	199,6	84	112
Percentage of total completions, %	22,4	13,9	8,8	4,2	3,5	3,2	1,5	1,9

Source: State Statistics Committee of the Ukraine, 2002



Figure 7

Dynamics of Housing Construction Financed from State Budget and Other Sources in 1991-2001, in percent to previous year



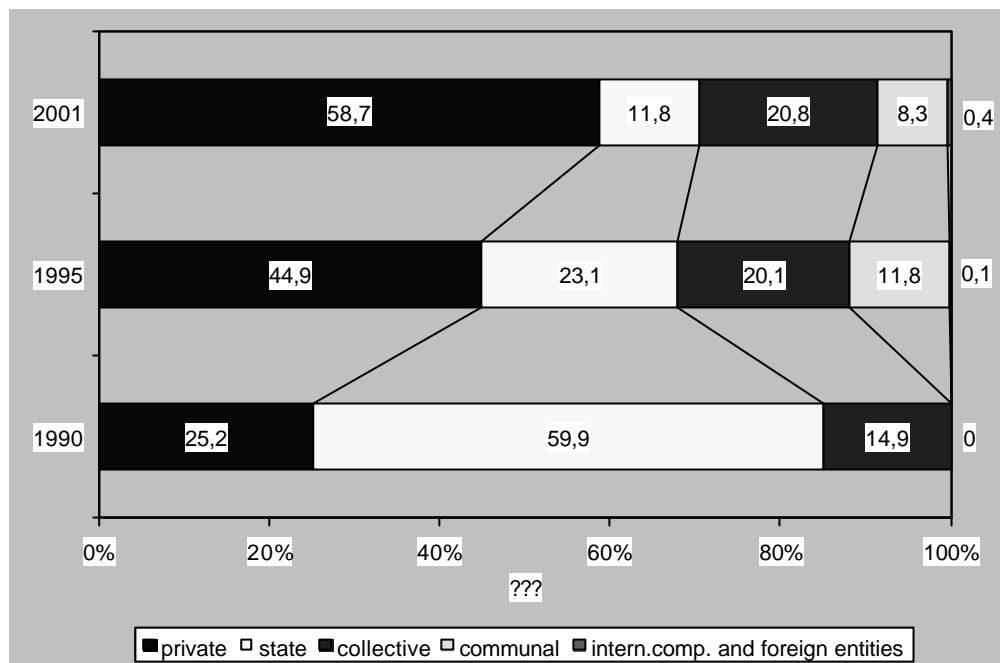
Source: State Statistics Committee of the Ukraine, 2002

The structure of the housing construction market by type of developed clearly demonstrates the trend toward a higher percentage of private companies, including individual developers. This is a normal phenomenon for the period of transition from a state-regulated economy to the market and reflects, first, the results of privatization on the construction sector, and second, the higher efficiency of private enterprises as compared to state or municipal enterprises (see Figure). Similar trends in the activities of construction companies are observed in all transitional economies.

Figure 8

Constructed Housing, by Type of Owner

(%of the total)

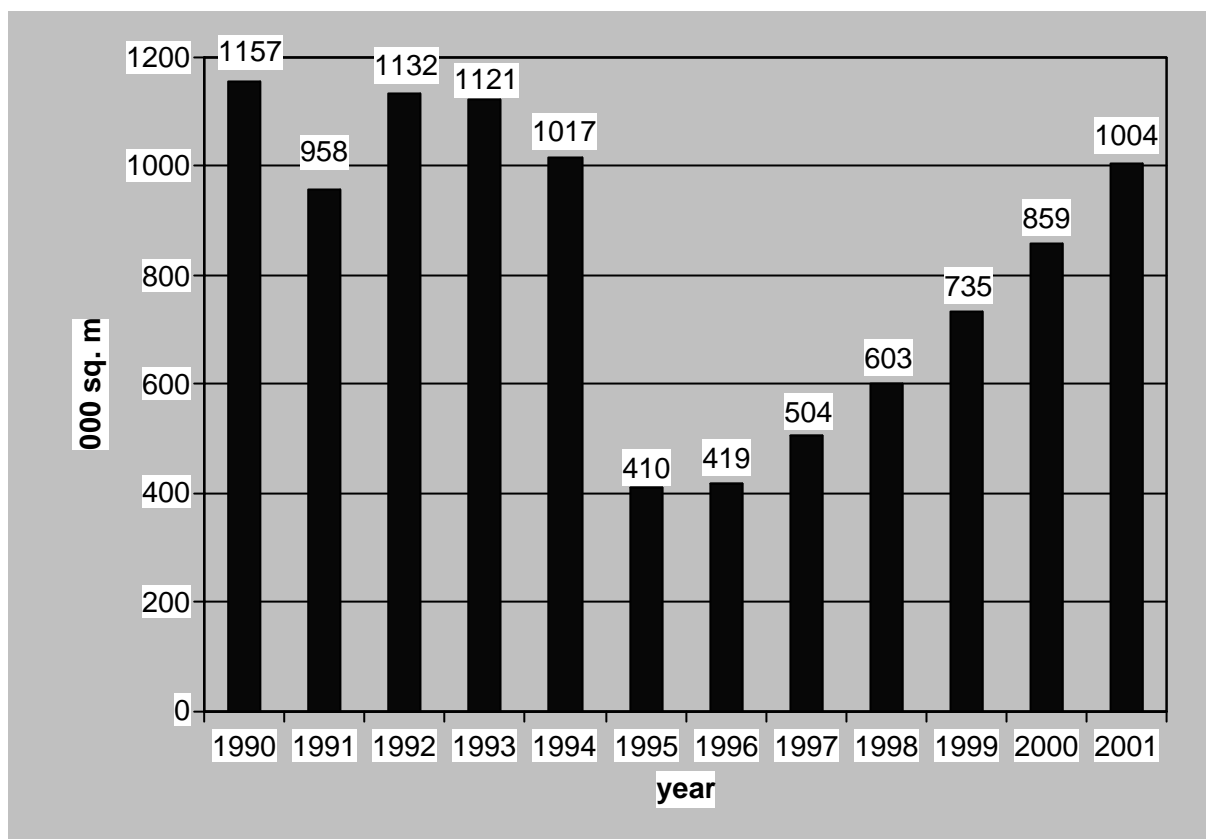


Source: State Statistics Committee of the Ukraine, 2002

The situation is more or less favorable in the Ukrainian capital. In the past 5 years the volume of housing construction grew steadily, adding 200 thousand square meters every year till 2001, when it passed the 1 million level (see Figure).

Figure 9

Housing Construction in Kiev



Source: State Statistics Committee of the Ukraine, 2002

The situation is much worse in other regions of the Ukraine. Certain activity is observed in selected regions only: Dnipropetrovsk Oblast, Donetsk Oblast, Zaporozhje, Lviv Oblast, Odessa Oblast, Poltava Oblast, and Kharkiv Oblast, while others are behind Kiev by ten and more times.

However, major Kiev construction companies are working to expand their activities in the regions, of which the most aggressive is the *Kyivmiskbud* Company. Following the scheme of this holding company, several construction projects were launched in Dnipropetrovsk, Chernovtsy, Odessa, Vinnitsa, and Zaporozhje; similar projects are under consideration in Poltava, Rovno, Donetsk and other cities of the Ukraine. Smaller developers from Kiev are trying to replicate this experience. However, the achievements of Kiev developers in the regions have been modest. The reasons are not limited to the low demand for new housing. The understandable unwillingness of local construction companies to open the local markets to competitors who, as a rule, have a stronger financial base is also a factor. Therefore, in the near future activities of major central construction companies in the regions will most likely be limited to a few projects of their own and collaboration with local developers under different arrangements.

Speaking about the secondary market supply of housing units, an interesting peculiarity may be noted. According to some forecasts, the primary market is growing so fast that in the near future it can outrun the secondary market in the volume of transactions. In reality this is not the case yet. This may be explained by the persistent trend on the primary for in-kind settlements between investors and developers: apartments, buildings or other constructions. The investor (usually a legal entity) is forced to independently sell these properties. Essentially, this sale of already constructed properties belongs to the secondary, rather than primary market. As long as such arrangements are used, the secondary market will see accelerated development, with a stable supply of new good-quality developments. Thus the two segments of the market for residential units are closely interrelated.

2.2.2. Demand

The attractiveness of residential units to prospective buyers is determined mainly by their incomes and respective buying capacity. The demand for apartments on the primary and secondary markets is driven, first of all, by prices. Other factors – qualitative characteristics, location, transportation access, floor, window view, etc. – are given a secondary importance.

At the same time, there is a general increase in the demand for higher quality units, and for the so-called “elite” housing that is emerging in several cities (Kiev, Dnipropetrovsk, Donetsk, Lviv, and Odessa). In the past few years, the concept of “elite housing” has acquired a clear definition. An elite unit is understood as an apartment in a building that has the appropriate service infrastructure: security, parking lot, modern communication facilities, life-supporting services, a solarium, health services, a shop, laundry, improved grounds, halls for visitors, etc.

According to expert reports, several years ago the dominating opinion was that apartments in old buildings are better than in new ones. However, with time the primary market has been able to offer apartments of a superior architectural and planning design, leading to a shift in consumer preferences.

Another reason for a stronger attention to the primary market is, probably, the growing economic literacy of prospective buyers, who, in addition to the purchase price, are now looking at the cost of future maintenance and repairs. From this perspective, a new unit is a clear win. This results in a flow of clients from the secondary market to the primary market. According to the estimates, in 2001 this flow amounted to an important 20 percent of all buyers.

In turn, the developers (*Kyivmiskbud*, *Poznyakizhilstroi*, *Agropromservice*) have taken additional steps to attract the investors and buyers: lower down payment, sale on an installment plan, and several others. (Modern methods of construction finance and lending for home purchases will be analyzed in the subsequent sections of the report.)

As reported by brokers and construction companies, the main buyer of housing is a medium-income person who has managed to save sufficient money for the purchase in the past years. In addition, many regional enterprises seeking to open a representation

in the capital buy offices and apartments for the staff. Some ministries and departments have started to buy real estate more actively. Also, many parents buy small apartments for their student children in the capital or some other big city. (This is one explanation for an increased demand for small apartments.) In general, a growing number of apartments in the capital is bought by households from other regions.

As regards the housing demand in the regions, some of them (Donetsk, Lugansk, Kharkiv oblasts) see the dying of small towns, as their residents of working age move to the regional centers. For this reason, in small towns the supply of residential units is much higher than the demand, which is close to the zero level.

The reverse side of this migration was the pressure on demand and prices for housing in the relatively better developed regional centers. For example, in Donetsk there is a strong demand for cheap units in the outskirts, as well as for expensive units in prestigious locations. As a result, from the fall of 2001 to the fall of 2002 prices for units in all districts of the city grew by 30 percent.

There is also a universal growing demand for production facilities, warehouses, and commercial real estate: shops, restaurants, cafes, etc. The trend is more pronounced in regional centers and major industrial cities. For example, in Kharkiv the volume of transactions in this sector reach up to 50 percent. Naturally, the demand affected prices: in Zaporozhje and Kharkiv, for example, the price of 1 square meter of such premises increased by 20-30 percent.

2.2.3. Population Incomes

As noted above, constraints of the income of prospective buyers is one of the main factors affecting demand. According to the most recent data of the State Statistics Committee of the Ukraine, the average household spending (the traditional statistical indicator giving a more exact figure for population incomes) in the Ukraine equals UAH 492.6 or USD 91.73 per month.² Interestingly, the increase in nominal income (by 18 percent in 2001), understandable in itself, is accompanied by the strengthening of the national currency with respect to the U.S. dollar (by 2.5 percent in the same period). Therefore, in dollar terms household incomes grew by 21 percent in 2001. Future tendencies are hard to predict as many of the political and economic risks remain high. However, one may expect the 2002 end-of-year indicators to be less impressive. At the least, available data may be regarded as more or less stable.³

² Statistics Yearbook of the Ukraine, 2002.

³ Here we are confronted with a well-known statistical problem of using income data. For a transitional economy, it is difficult to extrapolate past trends on the future without the danger of an over-optimistic forecast. In the reviewed case this danger is small because in case of any macroeconomic troubles (apart from serious crises) the strong upward trend of real income growth (the official 2001 inflation was a mere 6.1 percent) would merely become flat.

Additional information on the cash income and wages of the population, and some other market indicators is provided in the table below.

Table 10

Cash Incomes and Wages in the Ukraine

		1999	2000	2001
average per capita monthly income	UAH	103,30	146,31	187,29
	USD	25,01	26,90	34,88
average monthly wage (per one worker)	UAH	178,00	230,00	311,00
	USD	43,10	42,28	57,91
average monthly pension (per one pensioner)	UAH	60,70	68,90	83,70
	USD	14,70	12,67	15,59
average monthly spending (per household)				
- total	UAH	314,00	417,70	492,60
	USD	76,03	76,78	91,73
- in cities	UAH	350,10	457,60	540,30
	USD	84,77	84,12	100,61
- in rural areas	UAH	234,50	329,60	386,30
	USD	56,78	60,59	71,94
For reference:				
consumer price index		119,20	125,80	106,10
current dollar exchange rate in hryvna (end of period)	UAH	5,22	5,44	5,30
current dollar exchange rate in hryvna (year average)	UAH	4,13	5,44	5,37

Source: *Statistics Yearbook of the Ukraine, 2002*

2.2.4. Competition Among Developers

In the opinion of realtors, the secondary real estate market in most localities have acquires a more of less civilized shape. In many big cities, real estate agencies and brokers with the status of a private entrepreneur are used in about 85-90 percent of the transactions, with the exception of Zhitomir, where "black" brokers control about 40-50

percent of the secondary market, Odessa, Nikolaev, Kherson, and several lesser cities.⁴ As reported by the Association, at present there are 3-4 thousand real estate agencies. No one was ready to provide the figure for the “black” brokers.

The secondary housing market, primarily in Kiev, is definitely getting “younger”. This means that the market is offering an increasing number of recently constructed units, as a rule, from the largest construction company, *Kyivmiskbud*.

As a result of the minimum volumes of state financing in the past years, such recent giants as *Ukrbud*, *Kragprombud*, *Ukrtransbud*, *Mintrans*, and several others are no longer seen as competitors. The current leader is the *Kyivmiskbud* Holding Company, which builds housing in Kiev as well as several other regions of the country.

Kyivmiskbud has been able to attain the leading position among the developers for a number of reasons. Indeed, the company had a favorable starting position as a former major builder, and was one of the first to introduce housing construction mechanisms with the attraction of household savings (as will be discussed in greater detail in the subsequent sections). However, this scheme was strongly promoted by a special law of the Ukraine, *On Experiments in Residential Construction on the basis of the Holding Company Kyivmiskbud*. On the one hand, the law created a more progressive and favorable legal environment for the operations of the company, but on the other, it de-facto eliminated opportunities for an equal competition for all other companies, leaving them at an inferior level of legal support that is less efficient and less stimulating for the development of new forms of housing construction finance.

Despite the difficulties, many construction companies in Kiev, as well as other cities, have taken the road of maximizing use of household savings for financing construction projects. These companies include: *Poznyakyzhilstroj*, *Agropromservice*, *Kyivmiskbud-1*, *Ukraziabud*, *Karpatybud* (Lviv), *TMM* (Kharkiv), *Sozidatel* (Dnipropetrovsk), *Zaporozhinveststroj* and *Promindustria* (Zaporozhje), and several others. Of special note is one more adherent of this scheme of construction finance, the Chief Department for Housing Support of the Kiev City Administration, which is the second biggest developer in the capital, by the volume of attracted funds.

2.2.5. Prices

Several experts (for example, experts of the Ukrainian Association of Realtors) note that from the viewpoint of price fluctuations and price formation patterns, the Ukrainian real estate market has gone through five development phases. The first phase – 1993-1996 – initiated the formation of the market and was characterized by increases in the prices (on the average, dollar prices in Kiev grew by one fifth in 1995 and by one fourth in 1996) and in the number of transactions.

⁴ Data of the Association of Real Estate Professionals.

The second phase – 1997-1998 – was that of price stabilization and subsequent reduction that has started in the regions, reaching Kiev by late 1998. This was accompanied by a decrease in the number of market transactions.

The third phase – 1999-2000 – saw a dramatic decline in the prices in dollar terms. In Kiev, apartment prices in the course of two years decreased on the average by one third. In a logical market correction, the demand for housing increased, driving up the physical volume of the market. This, in turn, led to the appearance of new trends on the market, opening another phase of price growth.

The fourth phase – January to August 2001 – was marked by a slow but steady growth of the prices, particularly in the capital.

The last on-going phase began in the fall of 2001. Opinions on the reasons for the rapid growth of prices for housing and other real estate are varied. Most experts agree that the main factors are improvements in the economy and well-being of the population. Millions of people were finally paid the long-overdue wages and pensions, many enterprises regained ground, and many medium and small businesses stepped up their activities. Accordingly, the demand curve climbed fast.

In the common opinion, the September rise of the demand and, consequently, prices, was also caused by the dramatic increase in the instability as a result of the terrorist attacks of 2001 and the fluctuations on the world financial markets that followed them. Many people concluded that the economy of leading countries was on the brink of a deep crisis and hurried to convert their currency savings into physical form. Traditionally, the best investments in such situations are seen as real estate and jewelry.

Another version that deserves attention is that the Ukrainian real estate market responded to the transition of Western countries to euro. People, who held their savings or were paid in euro but, for one reason or another, were unwilling to take them to the bank for subsequent conversion into U.S. dollars tended to invest the money in real estate.

It is also probable that many people hurried to buy an apartment or house before the enactment of the Tax Code in the fear that it may require an income declaration for each big purchase. Also, rumors of new taxes on real estate transactions had been afloat for more than a year. In a long-standing tradition, legislative changes are most likely to become effective from January 1, and thus households tried to complete all major purchases before the New Year.

It is hard to judge which of the above was the deciding factor. Most probably, every one of them has to one or another extent contributed to the growth of real estate prices. In this case, of fundamental importance is the conclusion that real estate prices have acquired sensitivity to the demand and supply fluctuations which (particularly the demand) are determined by market factors. From the viewpoint of development prospects for the residential mortgage lending, one may reasonably assert that its broad implementation, all other conditions being equal, will have the most salubrious effect on the demand, stimulating it by an additional paying capacity. This means that the efforts to expand the residential mortgage lending activities are timely and will produce positive

effects in the housing and banking sectors, as well as in many other areas of the economy.

2.2.5.1. The Secondary Market in Kiev

Prices in the secondary market for residential real estate in Kiev have grown steadily, starting in the second half of 2000. Increasing by the average of 10-15 percent in the first half of 2001, by mid-year the prices soared. It was not stopped even by the seasonal factor – lowering of the market activity in the period of summer vacations. Moreover, the demand for selected types of units, in particular, one and two room apartments in mass developments, on occasion, turned into a real boom.

In the course of 2001 prices for one-room apartments in the outskirts made a gigantic jump of 40 percent. The second and third place was occupied by two and three room apartments in the same districts (35 and 30 percent, respectively). The increases were less in districts closer to the center, with 36, 30, and 23 percent; and still less in the center, with 29, 21, and 12 percent, respectively. The growth of secondary market prices slowed in early 2002. Average price growth amounted to 2.86 percent in January, and 0.71 percent in February. In the spring and summer changes in average apartment prices (regardless of the location, number of rooms, etc.) were insignificant.

Overall, the price structure on the capital's housing market may be described as follows. (A similar situation is observed in several other economic centers of the Ukraine.) the cheapest class is represented by small one room apartments, including those of the so-called "hostel" type with the total area of 20-22 square meters built 30 years ago or earlier. Units in panel buildings are about 10 percent cheaper than units in brick buildings. There is a high demand for one room unit in nine-storey buildings (\$ 11-13 thousand) and sixteen-storey buildings constructed during the eighties (\$ 12-15 thousand).

These patterns are also true for two and three room apartments. Thus, a two room apartment in a "Khrushchev-style" development costs 11-12 thousand dollars for a panel building, and 12-13 thousand dollars for a brick building. A similar unit in an old nine-storey building costs 13-15 thousand dollars, and 15-18 thousand dollars for a newer sixteen-storey building. Prices for three room apartments are about 30-40 percent higher. In old residential developments, such apartment will cost at least 16-17 thousand dollars, in new buildings, about 20-25 thousand dollars.

Particularly valued are apartments in the pre-war, so-called "Stalin" buildings with spacings of ferrous concrete. Two room apartments in such buildings cost 20-25 thousand dollars.

In central districts, a two room apartment without repairs will cost from 40 to 60 thousand dollars. A one room apartment in the center costs at least 25-30 thousand dollars, and a three room apartment, up to 100 thousand dollars.

Elite housing forms a separate category. This market segment is very narrow and, as usual, highly specific in terms of price formation. Nevertheless, in this case also, the demand showed a strong dependence on the market. At present, an elite apartment in the center of Kiev after renovation costs from 1,000 to 1,500 dollars per square meter.



2.2.5.2. Secondary Markets in the Regions

The increases in the demand and prices for real estate are not limited to Kiev through increases in real estate prices in major industrial centers were smaller than in the capital, with nearly no changes occurring in small towns and settlements, particularly for secondary units. Therefore, there is a clear dependence of price levels on the general situation in the economy.

The traditionally active regions characterized by relatively high prices, are represented by Kiev, Dnipropetrovsk, Kharkiv, and Odessa oblasts and the Crimea. One room apartments in mass demand there cost, on the average, from 5 to 12 thousand dollars, depending on the location. The cheapest housing is found in satellites of major industrial centers of the Eastern Ukraine, where a similar unit may cost not more than 1 thousand dollars (see table).

Table 11

Average Apartment Prices in Ukrainian Cities, 2002

City	Price by location, thou. dollars		
	center	close to center	outskirts
Donetsk			
1 room	5.5-11	5-7.5	2-4
2 rooms	9-17	6-12	3-5.5
3 rooms	13-30	9-16	3-8
Zaporozhje			
1 room	4.5-8	3.7-6	3-5
2 rooms	6-19	5.5-9	4.5-7
3 rooms	7-40	6.5-11	5.5-8
Gorlovka			
1 room	1.1-2	1-1.8	0.4-1
2 rooms	1.5-2.8	1.3-2.3	0.8-1.5
3 rooms	1.5-4	1.3-2.8	1-2.5
Zhitomir			
1 room	4-6	3.7-4.5	3.4-4.7
2 rooms	6.8-8.5	6.5-8	5.5-7.8
3 rooms	8.5-12	7.5-11	6.8-9.5
Lviv			
1 room	10-12	8-10	4-6
2 rooms	17-19	14-16	9-11
3 rooms	29-32	25-27	15-18
Poltava			
1 room	6-8	5-6	4.2-5
2 rooms	10-15	7-10	6-8.5
3 rooms	20-35	13-18	7.5-10
Simferopol			
1 room	6.5-7.5	6-7	5-5.5
2 rooms	9-12	8-10	6-7
3 rooms	12-20	10-16	8-10
Chernigov			
1 room	4.5-6	3.5-5.5	3-4
2 rooms	6.5-8	5-6.5	4-5
3 rooms	8-16	6-8	4.5-6

Source: Informational bulletin, "Janus neruhomist", No. 19 (200) 10.2002.

At present, a highly active real estate market is observed in the coastal cities of the Crimea. In the opinion of the real estate brokers, the greater portion of residential real estate goes to buyers from other regions or countries, rather than the local residents.

The units are used either as a summer residence or as an income-generating rental property.

Consequently, proximity to resorts and access to the sea become the key pricing considerations. The highest prices have formed in Yalta. One square meter of a residential unit on the embankment with a view on the sea will cost at least 1,500 dollars; 900-1,000 dollars at a 5-minute walking distance from the sea; and 500 dollars at a 10-minute distance; and if the distance to the sea is more than 2 kilometers, the price will usually not exceed 300-500 dollars. Particular attention in 2002 was attracted by Sudak: apartments in this coastal town turned out to be the cheapest compared to other resort towns (from 4 to 8 thousand dollars), and thus enjoyed unprecedented demand.

Table 12

**Average Apartment Prices in Crimean Cities
(U.S. dollars, 2002)**

City	1 room	2 rooms	3 rooms
Koktebel	6-11	8-14	13-18
Feodosia	5-7	7-10	15-20
Evpatoria	5,5-12	7-20	12-30
Alushta	7-15	11-25	13-33
Sevastopol	4-25	7-36	11-75

Source: *Informational bulletin, "Janus neruhomist", No. 19 (200) 10.2002.*

2.2.5.3. Primary Market Prices

The increased demand for real estate in general lead to increases in both secondary and primary market prices. As noted above, about 20 percent of the buyers moved to the primary market. In 2001, prices for newly constructed units grew by about 20-30 percent in Kiev, and by 10-20 percent in the country in general.

In the opinion of construction companies, apart from the higher demand, the price growth on the primary market was caused by a number of "objective", from their viewpoint, supply-side factors. In Kiev, for example, the weightiest factors are, first, the decrease in the number of available cheap construction sites that do not require additional capital investment in engineering and other infrastructure; and, second, the growing construction costs due to the price hikes of power and heat providers and producers of concrete, glass, and metal. These companies are enjoying a monopolistic position, as they have successfully lobbied for higher custom duties on imports from the neighboring countries. The third "objective" factor is perceived by the builders to be the centralized planned increase of the average wage standard for the sector.

One square meter of housing in a new building at the outskirts of Kiev costs 250-300 dollars. A unit closer to the center costs not less than 700 dollars per square meter. In central districts the price may be as high as 1,000 dollars. As regards new elite

housing, a unit in this class with a good floor plan may cost from 1,000 to 1,800 dollars. The prices for new housing in regional centers are lower by 20-50 percent. However, the primary market may be included into the price analysis of housing affordability only with the reservation about the limited volumes of housing construction in the regions.

Table 13

The price of 1 sq.m. of total area in apartments produced by Kyivmiskbud Holding Company

Region	Price			
	2001		2002	
	UAH	USD	UAH	USD
Osokorki	1,280	238	1,757	325
Poznyaki	1,402	261	1,750-1,760	324-326
Troeschina	1,081	201	1,480-1,500	274-278
Vinogradar	1,371	255	1,691	313
Darnitsa	1,323	246	1,485	275
Rusanovka	-	-	2,440-2,800	452-519
Svyatoshin	1,651	307	1,794	332
Novobelichi	-	-	1,647	305

Source: *Informational bulletin, "Janus neruhomist", No. 19 (200) 10.2002.*

Importantly, nearly all units in new and even uncompleted buildings are sold long before the end of the construction, though only two years ago, according to expert reports, buying a unit in a newly constructed and commissioned building was not a problem.

Most experts agree that the current prices are close to the maximum, and thus no decreases should be expected. The most likely forecast is that prices will stabilize first on the secondary market, and then on the primary market if no exceptional developments occur in the economy and politics.

2.3. General Situation on the Market for Commercial Real Estate

The Ukrainian commercial real estate market is distinguished by a relatively stable dynamics of sales which in 1997-2001 varied from USD1 million to USD 2 million. Today, most promising segments of this market are offices and administrative buildings, industrial property and warehouses.

As regards the capital, in the opinion of several specialists in the future Kiev will profit from its advantageous geographic position in Europe. The increased interest in investments for commercial office premises is connected, first of all, with the inflow of foreign and out-of-town entrepreneurs who are actively hunting for a place to house their representation offices. At present, there is a deficit of these premises, including offices to let.

Trading spaces represent another promising area of the commercial real estate market in Kiev. Realtors report a significant growth of demand for shop leases in the last time. There is a stable interest in any trading space from 40-100 to several thousand square meters. At the same time, the supply of high-class trading centers, with convenient shops, stylish design, modern ventilation system, security and parking lots is low, and properties of this type are also in deficit.

In view of this market trend, redevelopment - conversion of existing real estate objects into commercial properties that are in demand – becomes one of the quickest and profitable ways of generating income. With a quick partial reconstruction, former industrial or administrative buildings may be turned into offices, shops, sports clubs, and restaurants. Investments in such properties may be recovered within 3.5-4.5 years from rent payments alone (not taking into account the increased value of the property).

The trends clearly observed on the commercial real estate market in Kiev are also characteristic of the regional centers, though the level of demand and supply on regional markets is determined by the household incomes and financial capacity of local enterprises as potential buyers or lessees of one or another type of real estate. Regretfully, at present one may hardly speak about any significant potential of the commercial real estate markets in small towns and rural areas because the general situation in their economy is still too close to a crisis.

One factor obstructing development of the market for non-residential real estate is the lack of reliable information on the supply, demand, prices and market dynamics. In many cases the information on actual market transactions is closed, which is characteristic of many segments of a transitional economy. Regretfully, the informational deficit on the market for non-residential real estate turns price formation into a chaotic process.

Summing up, the commercial real estate market has emerged and is fairly well developed in industrial and economic centers of the Ukraine. Still, it may hardly be regarded, at least for the present, as a strong competitor of the housing market for prospective investments. Evidently, the capacity of either market is not big enough to present an investment alternative to a major investor. In addition, as long as demand for housing does not drop to reasonable levels (as indicated by price stabilization), the rate of return in the housing sector will be comparable to that of commercial real estate, or even exceed this indicator.

2.4. Land Market

Land remains one of the most important and broadly debated issues. The results of the land reform, which is the cornerstone of market transformations in any country with a high agricultural potential, have so far been unsatisfactory. Formally, the markets for urban and agricultural land have been created. In practice, however, nothing has changed.

As regards agricultural land, 6.4 million Ukrainians have been given, on the average, 4.1 hectares each. At present, most of them have state acts verifying their ownership of

the land. Others should get the papers in the near future. This, however, is where the market reforms end. Ownership of the land granted in the process of initial privatization may not be effectuated through, for example, sale or mortgage of the land. By decision of the Supreme Rada, public conveyancing of agricultural lands is suspended till 2005. At that time holders of land certificates and state acts on ownership of the land will be able to sell or buy land, though the subject plot may not have more than 100 hectares. Restrictions on the transfer of land will be removed in full only after 2010.

In principle, the situation is better for urban lands, as there are no legislative restrictions on the purchase, sale or other use of land plots. Nevertheless, the land markets in cities are weak. The reason is that the key owners – city administrations – have no incentives and are unwilling to part with their ownership rights. As a practical matter, when a new construction project is involved, developers are offered the so-called “land allocation” scheme, i.e. short-term (for the construction period) right to use the land plot exclusively for the purposes of construction of a pre-agreed and approved project. After that, several options are available: the land may be retained on the balance and thus in the ownership of the city, while the new owner of the building is granted the same right of use which is legally tied to the right of ownership to the building, and the right of lease for the adjacent land plot; or the land plot may be sold to the new owner. So far, cases of a developer acquiring lease rights to the land already at the construction phase are few.

The core of the problem lies in the unwillingness of the city authorities to transfer ownership of the land, because of the perceived loss of control over the use of city lands. (In reality, the issue may be readily addressed by the introduction of legal zoning rules.) lease and ownership of the land for new developments are granted in a rare cases and with the use of not always transparent procedures. As a result, project developers and owners are practically unable to use standard western practices of attracting bank loans by mortgaging the land plots under construction sites because short-term leases (the best currently available option) have low liquidity as compared to long-term leases or ownership rights, while “land allocation” is not a transferable right at all.

A relatively favorable situation is observed for enterprise lands, many of which were privatized in 1997-2001 or are being repurchased now. One should note the important contribution to the development of practices and procedures of enterprise land sales of a special program, *Sale of Non-Agricultural Lands to Sitting Enterprises*, implemented in 1997-2000 with the support of the USAID. Among the most important achievements of the program is the creation of first precedents and then practices of enterprise land sales. The expansion of these practices will give enterprises a liquid asset, on the one hand, and generate revenues for the city budgets in the form of sale proceeds and land taxes. See the Attachment for more information on this project.

2.5. Infrastructure

The functioning of the real estate market is largely dependent on its infrastructure which includes brokerage, appraisal, insurance and other services. In the opinion of professionals, in the past 10 years few changes occurred in the infrastructure, which no

longer meets the needs of the market. This predetermines the non-transparency of operations and creates opportunities for violations of the law, driving away prospective investors. In this connection, the development of an infrastructure that answers modern requirements is a critically important task.

The lack of legislative regulation creates serious difficulties for various participants on the real estate market. However, the greatest concerns are caused by the lack of a systemic approach to the drafting of relevant laws and regulations or a unified concept for the development of the real estate market. Documents submitted to the Supreme Rada and the Cabinet of Ministers often contradict one another.

While basic elements of the market infrastructure are in place, the volume of services is too low to speak of a high development level. The most developed area is real estate brokerage. The Ukrainian Association of Real Estate Market Professionals (Realtors) established in 1995 has gone a long way from the participation in selected transactions, which were disparate and often connected with the shadow economy, to the efficiently structured activities.

On the weak side, one should note, first of all, the poor transparency of the activities. Despite that most transactions with real estate are brokered, as reported by the brokers themselves, even the basic data on the number and volume of transactions with real estate of different types are extremely difficult to obtain. Another problem is presented by the lack of a system for cutting off unscrupulous or unprofessional operators, and the lack of unified standards.

The informational support of the real estate market needs to be moved to a new level of quality. At present, Kiev has six major trade publications: *Nedvizhimost Kieva*, *Vestnik Nedvizhimosti*, *Janus Neruhomist*, *Nedvizhimist Komfort*, and the *Avizo* newspaper. Similar publications, though in smaller numbers, are available in the regions. However, there is as yet no demand for (or access to) analytic materials and reliable data bases, without which no respectable program of a republican or regional level may be designed. It appears that mechanisms for collecting and maintaining reliable data, and providing access to it for market professionals may not be installed without the initiative of the state.

Independent appraiser firms are seasoned operators on the real estate markets. Nevertheless, their activities on the housing market, particularly the market segment where units are acquired with the use of a bank loan, are negligible. The point is that price negotiations between individual sellers and buyers are often held without the participation of appraisers: if the price is found acceptable, the deal will be done. Buyers of apartments as an investment are few, though their number is growing steadily. Companies also prefer to negotiate their deals independently, without the reliance on carefully calculated market price indicators. As regards banks lending against real estate, their relations with certified appraisers are based exclusively on compliance with the law and are usually limited to checking for the possible understatement of the collateral value. A real need in independent appraisals is more likely to appear only when the market has achieved adequate quantitative and qualitative growth levels.

The insurance sector is represented by several insurance companies, though the assets of most are closely tied to major banks and enterprises. Their services on the real

estate market are limited to property insurance. No insurance is available for borrower's liability, financial risks, or loan non-repayment risk (including a mortgage loan). Thus much remains to be done to create preconditions for the appearance of these and other insurance services on the market.

Another promising service is management of real properties which, however, is not present on the Ukrainian real estate markets as a professional activity. This is explained by the lack of balance in the system of rent and utility charges; the difficulty of organizing a condominium in view of the incomplete privatization of the housing stock that hinders efficient management; the practices of managing commercial properties mainly by strategic investors; and lack of professional expertise in property management.

Financial services are newcomers to the real estate market, and have yet to form a system for this market segment. This does not concern residential mortgage lending only. At the same time, one may note the formed practices in lending against the collateral of real estate, which will be discussed at length in the next sections of the report. A multitude of ideas around the development of the national mortgage market have been implemented in practical projects, few in number but important for the emerging market. For example, the creation of the national Mortgage Association of the Ukraine in 2001 is a major achievement. The Association attempts to unite all healthy approaches to the organization of the market and propose concrete actions for the introduction of mortgage in the Ukraine. Nevertheless, these are just the first steps on a long way.

A few words should be said about real estate investments. Just as mortgage lending, this business is highly sensitive to the general situation in the economy. In 1998 these activities were gaining momentum, to be abruptly interrupted by the financial and economic crisis, as a result of which one half of the going projects were suspended. At present, professional investment activities cover only Kiev and several other big regional centers (Kharkiv, Dnipropetrovsk, and others) with the total number of enterprises in the country, according to expert estimates, not exceeding 30. However, enterprises which provide the entire package of investment services are nearly non-existent, despite the potential promise of this line of business. At present, investments on the real estate market go mainly into relatively small projects, like offices, cafes, and gas-filling stations.

Importantly, many representatives of the above listed businesses are seeking to accelerate the solution of the tasks that need to be resolved for the development of the real estate. At the same time, the search for new efficient ways of addressing these issues should be continued. In particular, the tasks that have been formulated by the professional real estate market community include:

- creating a unified concept of real estate market development;
- introducing regulation in the professional environment and a system of consumer rights protection;
- developing the real estate market infrastructure;
- enhancing the investment attractiveness of real properties.



The discussion of these and other issues on the agenda showed that many need clarification and detailed review, while the goals, as such, are undoubtedly correct. The final section of the report will present our understanding of the priorities and strategic tasks that need to be addressed for further development of the real estate market and market infrastructure.

3. Current system of housing financing

3.1. *Principal subjects of housing financing system. The role of the state in financing the housing sector*

At this time, housing financing is performed by the state at the expense of the federal and local budget funds, by construction agencies at the expense of their own or borrowed funds, by institutional investors, banks and private citizens.

The role of the state in providing housing for the population have been considerably reduced in the course of 90-s, provision of free state housing is very limited and covers only very narrow segments of the consumer market. Budget funds are used to implement a number of state assistance programs aimed at improving the housing conditions of certain categories of population.

Thus, the most actively implemented program is the program of housing provision to the young population, under which housing loans are granted to young families on easy terms. In addition to this, there is also the Own Home Program, which provides for financing of housing construction in rural areas with subsequent in-kind repayment of the loan. Also, there are housing financing programs for the military personnel and victims of Chernobyl Catastrophe, which allocate state funds for construction of housing for these categories of population.

The main sources of housing construction financing and improvement of housing conditions of the population are private investments, own funds of citizens and bank loans. The most widely used are the schemes of attracting citizen's funds for financing of housing construction under the investment agreements. To a lesser degree, bank loans are used by the citizens for purchase of housing. This can be explained by insufficient development of the housing mortgage lending market and existence of tax exemptions for investment into construction.

3.2. *State financing in the housing sector*

The program of provision of housing to the young population is implemented by the Fund of Assistance to Housing Construction for the Youth, which was established especially for this purpose by the Ukrmolodzhitlo All-Ukrainian Association. The Fund is a specialized financial institution.

The purpose of the program is to solve the housing problem of the young population by providing them with soft long-term loans for the construction of housing.

Funds of state and local budgets, citizens' savings and other funds serve as sources of financing.

Under the program terms, the loans can be granted to young families (spouses under 30 years old or singles under the age of 28). The loans can only be granted to those who are on the Waiting List for housing conditions improvement.

The loans are granted for the period of up to 30 years, for participation of citizens in the construction of housing. The loans are secured by property rights under investment agreements and, upon completion of construction, by mortgage on the housing. Program participants can purchase apartments in the houses being constructed under this program by construction companies, selected through competitive process. The Fund plans to further develop the mechanism of providing housing to young families and introduce the practice of financing the purchase of existing real estate at the primary and secondary market.

The loans are granted at the interest rate of 3%. This interest rate is subsidized by the state and compensated with the program funds.

The program puts a clear emphasis on demographics, which is most evident in the interest rate policy. If the family has one child, the loan is interest-free. Families with 2 children are given subsidies in the amount of 25% of the loan amount, and families with 3 children - the subsidies in the amount of 50% of the loan amount.

The downpayment amounts to 6% of the total value of the apartment. The value of the apartment is determined on the basis of the average price per 1 m² of housing in the region. The loans are granted for the housing, which satisfies the following standard area requirement: 21 m² per person plus 20 m² per family.

In order to receive the loan, the borrower has to take out insurance on the housing being purchased.

The following table contains some figures reflecting the situation in providing loans to young families.

Table 14

The Volume of Housing Loans to Young Families

Year	De-facto Financing from State Budget, (UAH, mln.)	De facto Financing from Local Budgets (UAH, mln.)	Total Loans Granted	Number of Regions Participating in the Program
1998	6,2	8,5	343	13
1999	6	11,7	348	22
2000	70	14,7	1287	27
2001	49,7	7,9	1068	27

The Fund of Assistance to Housing Construction for the Youth has created a network of branches throughout the country.

At this time, measures are being taken to ensure the funding of the program implementation in the future years. It is planned to spend about UAH 70 million for this purpose in 2003.

State program Own Home is being implemented in the rural areas. It is aimed at the support of construction of private housing. Loans are granted at preferential interest rate of 3% p.a. The borrowers can repay the loan not only in monetary form, but also in kind.

In addition to these programs, a housing program for military personnel and victims of Chernobyl Catastrophe is also implemented in the Ukraine. Under the housing program for the military the houses are constructed and apartments in them are given to military personnel. The program is financed with the budget funds. Under the current legislation, 1.5% of the collected amount of the company income tax is transferred into the program fund.

In general, it can be noted that the existing programs of housing financing assistance to certain categories of population use similar mechanisms - the housing is constructed mainly at the expense of the budget funds. Then, the housing is either given to eligible categories of population or sold. The citizens purchase this housing with their own funds, as well as using the loans subsidized by the state.

3.3. Banks on the housing financing market

In order to examine the situation in the housing mortgage lending sector, the activities of a number of banks operating on the market were analyzed.

At this time, about 120 banks are operating in Ukraine, 2 of them – fully owned by the state: Oschadbank and Ukreximbank. The following banks can be named among the largest Ukrainian banks: Oschadbank, Ukraine Bank, Ukreximbank, Prominvestbank, Ukrasotsbank, Aval Bank, Privatbank. The same banks have the biggest number of branches in all the regions of Ukraine.

The resource base of the banks is of a rather short-term nature and consists of the funds deposited by natural and legal persons, usually for the term less than one year.

Loans constitute about 43% of the active transactions of the banking sector, and 95% of the credit portfolio consists of commercial loans to companies and organizations, while only 5% falls to crediting natural persons - mainly consumer crediting.

Loan terms are determined by such factors as high crediting risks, short-term resource base of the banks and general economic instability: the banks mostly issue short-term loans for the period of less than one year, normally – just for 3 months.

The most active participants of the retail banking market are Privatbank, Aval Bank, Oschadbank, Praveks Bank. Loans to natural persons are mostly consumer loans, and mortgage loans amount to no more than 15 - 25% of the total volume of the consumer loans in these banks.

Lack of interest on the part of the banks in developing the practice of housing mortgage lending can be explained by the following reasons:

- absence of internal sources of long-term money, necessary for issuing long-term mortgage loans;
- the volume of long-term mortgage lending is limited by the short-term resource base of the banks, as increasing the share of long-term loans could have a negative impact on the balance liquidity of the bank;
- high price of borrowed resources for the banks determines the price of the loans;
- undeveloped legislative framework in the field of mortgage lending leads to high risks of housing mortgage lending, which in turn, lead to high interest rate on the loans issued by the banks;
- the risk associated with legal and judicial difficulties arising in case of foreclosure or eviction or borrowers and subsequent sale of mortgaged property is estimated by the banks as rather high, which causes them to raise the interest rates on the loans granted to the population;
- low profitability of mortgage lending activity for the banks, if compared to other fields of banking activity;
- high prices of mortgage loans make them unaffordable for the vast majority of population; low demand for mortgage loans thus limits the development of this type of banking business;
- difficulties in analyzing the borrower's solvency, high share of unregistered income in the income of the population;
- lack of people's trust in banks reduces the possibilities of accumulating on bank accounts the funds that can be used for downpayment, which in turn lowers the resource capabilities for crediting and hinders the establishment of normal relationship between creditors and borrowers.

Consequently, under the current conditions, the banks view the transactions on granting housing mortgage loans to population or construction loans to the developers as high risk and not sufficiently profitable. As a result, direct contribution of funds by the population or separate investors still continues to be the main financing source for housing construction and purchase.

Creation of a reliable banking system of long-term housing mortgage lending, as well as the size of potential mortgage lending market, depend on a number of conditions, such as:

- efficient legislative environment in operation
- sufficient effective demand for mortgage loans on the part of the population
- affordability of mortgage loans to population, which is determined by the interest rates, duration of credit period and real estate prices
- level of development of the banking system;

- creation of proper environment for efficient attraction of long-term credit resources to the bank crediting sector for issuing housing loans;
- situation in housing and housing construction markets and their development prospects.

It has to be noted that banks are starting to pay more close attention to the development of retail business. In the last couple of years, most of the leading Ukrainian banks have started to perform housing mortgage lending transactions.

The prospects of mortgage lending development in Ukraine are determined by a number of factors.

At this time, the banks have considerably raised their capitalization and encountered the problem of placing their funds into efficient and reliable active operations. The lack of reliable long-term financial instruments of sufficient volume forces the banks to look for new types of active operations. Limited number of efficient financial instruments available to banks has lead to their increased interest in the housing financing sector.

Recently, the deposits of the population started to grow and the terms of deposits have somewhat increased. Thus, deposit terms have grown to 1 year or even more. In order to invest these funds, the banks began to develop actively the retail crediting transactions - primarily, issuing loans to individuals for purchase of cars.

The increase in the volume of resources attracted by the banks coincided with the increased demand of the population for housing mortgage loans. The latter fact can be explained by growing income of the population and their inability to improve their housing conditions at the expense of the state.

At this time, the banks mainly offer financing of share participation in construction of housing. In the future, the market of existing housing is expected to increase its activity. In this situation, loans granted for purchase of housing on the secondary market will gain the most importance.

There is a noticeable trend toward lowering of interest rates on housing loans, which will lead to their increased affordability for the population and growth of the credit volume.

An important factor of housing mortgage lending development will be represented by the results of the ongoing work on forming the legislative basis for housing mortgage lending, which should lead to lowering of mortgage lending risks, increased attractiveness, reliability and efficiency of this type of banking activity.

3.4. The practice of bank operations on the housing financing market

Banks operate on the housing financing market in two ways: providing loans for construction of housing and housing financing to the population.

At this time, there are two main forms of banks' participation in financing the improvement of the housing conditions of the population:

- lending to citizens financing construction of residential buildings on the share participation basis;
- financing the purchase of completed housing.

In addition to this, loans for renovation of completed housing are becoming more and more popular. This is a new segment of the housing financing market, the demand for which is steadily growing.

Out of the housing loans granted to population, the majority was granted for share participation in construction of residential buildings.

According to expert opinions, based on the data provided by the banks and specialists working in the housing financing sector, the share of mortgage loans in the credit portfolio of the banks is still rather small and comes to 1-3% on the average. However, many bankers view the housing financing market as promising, much needed and growing.

Certain features of housing financing of the population are common to both the financing of share participation in construction and financing of completed housing purchase.

At the stage of deciding on the loan issue, while analyzing the solvency of a prospective borrower, the bank takes into account not only his official income but also his unofficial (shadow) income as well. The problem of evaluating the actual solvency of the borrower presents serious limitations to the possibilities of developing housing mortgage lending. The banks apply their own indirect techniques of solvency analysis, which in reality may not always correspond to the actual solvency of the borrower. This raises the credit risk that the banks take into account when establishing the interest rate on the loan.

Informal approach to the solvency analysis will present a serious limitation factor on the way of development of standardized primary and secondary markets for housing mortgage loans. Non-transparency of the borrower's income limits the interest of the investors, who have long-term resources available for possible investment into the mortgage lending sector.

The banks perform housing financing in UAH as well as in USD, in order to protect themselves from risks. Formally, current legislation prohibits granting of foreign currency loans to natural persons. However, in practice, the banks use various payment techniques, which enable them to perform financing in foreign currency, e.g. by way of effecting loan payments through foreign currency plastic card accounts. This payment technique bears the risk of possible use of credit funds for a different purpose.

Participation of insurance organizations in the process of housing financing deserves a special mention. The banks now require that the borrower take out insurance for loss or damage of the real estate serving as security for the loan. The cost of such insurance for the borrower comes to 0.5% - 2% of the loan amount.

The market of life, health and disability insurance is at the stage of initial development. Therefore, under the existing housing financing programs the banks do not require personal insurance of the borrower. As this segment of insurance market develops

further, this type of insurance should become an indispensable part of the loan agreement and mortgage agreement.

3.4.1. Financing of share participation in construction

This type of financing is used by the banks, which cooperate closely with developers or have developers among their customers. The pledge of the citizen's property rights under an investment agreement serves as security for such loan. Upon completion of construction, a mortgage agreement is made for the completed apartment, registered as property of the borrower. The principal participants of this particular sector of housing financing market are Arkada Bank (whose credit terms differ from that of other banks as the bank is implementing an experimental program, approved by the law of Ukraine), Ukrspotsbank, Aval Bank, Tavrika Bank and others.

Principal conditions of this type of financing are as follows:

- The loan amount comes to 65-70% of the value of housing;
- Loan currency is UAH or USD;
- Interest rates come to 14 – 18% p.a. in foreign currency; 20 – 26% p.a. in UAH;
- Term of loan is 1 – 3 years, in some banks – 5 years;
- Borrower's solvency requirements: loan payments may constitute 30% to 60% share of the borrower's income, which includes both his official and unofficial (estimated by indirect methods) incomes.

Issuing loans to citizens for the purpose of financing their obligations under the agreement on investment into housing under construction is a rather risky type of credit financing, as in this scheme the credit risks are intensified by the construction risks. In addition, there is also the risk associated with the certain features of the investment agreement. The rights to the house under construction belong to the investors and share participants in the construction. As agreements on share participation are not subject to any compulsory registration, there is a danger of concluding so many of these agreements that their number will exceed the actual number of apartments constructed. The situation may arise when several people will claim the same apartment. And as the loan is secured by the property rights under the investment agreement, the bank may find itself having issued a loan which is actually unsecured.

In order to avoid this risk, the banks prefer to deal with developers, who have strong economic ties with the banks, whose activity is transparent for the banks, and who have established reliable and trustful relationship with the banks, preventing the possibility of unfair action.



Table 15

Terms of loans for participation in housing construction, provided by some Ukrainian banks

Banks	Loan currency	Interest rates	Loan term	LTV
Arkada	OdIn ⁵	10,5%	?? 30 ???	65%
Ukrsotsbank	UAH	20-26%	3 years	70%
	USD	12-16%		
Forum	UAH	20-22%	3-5 years	70-80%
	USD	18%		
Tavrika	UAH	24-25%	Up to 1 year	70%
	USD	18%		
Aval	UAH	24-25%	Up to 5 years	70%
	USD	14-18%		

3.4.2. Financing of the purchase of completed housing

A growing number of banks are starting to perform financing of the purchase of completed housing: Pravex Bank, Privatbank, Aval Bank, Oshadbank, Ukrsotsbank and others.

Principal conditions of this type of financing are as follows:

- Loan amount – 50 – 70% of the assessed value of the apartment;
- Loan security – pledge of the purchased housing under the mortgage agreement;
- Interest rate – 14 – 16% p.a. in foreign currency or 20-25% p.a. in UAH;
- Loan term – up to 5 years;
- Loan repayment: as a rule principal amount is repaid by equal monthly installments together with interest on the remainder of the debt;
- Independent appraisal and insurance of the real estate is required.

Some banks (e.g. Nadra and others) prefer to issue loans to citizens who have participated in the construction and want to purchase already completed housing (so called “loans for further purchase”). These are relatively small loans issued on the

⁵ Investment Unit (Ukr.) – a special unit for calculating loans principle invented by Arcada Bank solely for its residential lending program (see details below).

security of the purchased housing. These loans are often granted together with loans for renovation (outfitting) of new housing.

One of the problems of financing the purchase of completed housing is presented by the gap between the time when the mortgage agreement is made and the time when the bank transfers the loan funds to the borrower, enabling him to register his property rights to the real estate. Banks find various solutions to this problem. Some banks require property guaranty from the seller for the period of completion of documents establishing the right to the real estate, and conclude mortgage agreement for the apartment, which does not yet belong to the buyer. This period can last from 1 to 2 weeks. After this, mortgage agreement is concluded with the borrower, who has acquired the property rights to the real estate. This method is often used by the construction organizations and investment companies, when they sell completed housing.

Other banks act as agents of the borrower in the process of completing all required documents in connection with the purchase of housing and registering the property rights to it with Technical Information Bureau, and keep all the documents so as to protect themselves from all possible risks.

Table 16

Terms of loans for the purchase of housing, provided by some Ukrainian banks

Bank	Loan currency	Interest rate	Term	LTV
Oschadbank	USD	14%	5 year	70%
Privat bank	USD	15%	5 years	50%
Aval	USD	24-25% 14-15%	5 years	70%
Forum	USD	18-22%	5 years	70%
Nadra	USD	23-23,5% 16,5%	1-3 years	70%
Ukrsotsbank	USD	16%	3 years	50%
Pravex-bank	USD	15%	5 years	70%

3.5. Practice of certain banks in the field of housing financing

In this section we present the approaches to housing financing used by some of the banks, with which we held meetings in order to discuss the specific features and problems of the housing financing in Ukraine.

3.5.1. Arkada Bank

Arkada Bank has been operating in the housing financing sector since 1995 and is the only Ukrainian bank specializing in housing financing. Together with Kievgorstroy Holding Company the bank implements housing construction programs with the attraction of the funds of the population.

The bank implements various schemes for citizen's participation in investment into the housing construction.

1. At the initial stage of construction, the customer chooses the apartment and pays for it in full, becoming the owner of the housing upon completion of construction. The price per square meter at the initial stage of construction is much lower than at the end of construction period.
2. The customer selects the apartment at the initial stage of construction and pays for it by regular installments. The customer makes downpayment in the amount of 30% of the value of the selected apartment, and the remaining part of the apartment value is paid by equal monthly installments. Three months before the completion of construction the apartment has to be fully paid up. Under the program terms, the price per square meter can vary within 5-10% of the base price.
3. The customer opens a special savings account with the bank, on which he accumulates at least 30% of the apartment cost. Upon accumulation of the required amount, the customer can use it for construction or purchase of an apartment and receive a loan.

It has to be noted that under these schemes of construction financing the bank acts as an agent of Kievgorstroy Holding Company, attracting the funds into construction, working with the customers, providing consultations, concluding deals, effecting payments and so on. The bank serves as a trust manager for the citizens' investments in the construction.

Arkada Bank provides long-term housing loans to Ukrainian citizens between the ages of 18 and 60 for the period of up to 30 years. The loan is issued in UAH. For the purpose of calculation of the loan amount, interest amounts and loan payments, a special measurement is used - the unit of investment (adjusted standard unit of account) - "Odln". "Odln" is calculated on the basis of official inflation index indicators, index of industrial products prices, index of prices for construction and installation works, etc. This bank determines this indicator independently using its own technique.

At this time, the interest rate on loans is set at the level of 10.5% p.a., in "Odln".

Before the completion of construction, the borrower pays to the bank only the interest amounts, and upon the completion of construction the borrower starts to repay the principal debt amount by equal quarterly installments, as well as interest on the remainder of the debt.

Different interest rates are set for the loans issued under the housing savings program. The borrowers who accumulate savings on their deposits in accordance with the established schedule pay interest on loans at 4% p.a., in "OdIn". At the same time, interest is being accrued on their deposits at 1.5% p.a. The borrowers who make deposits at random pay interest on loans at 5% p.a. in "OdIn", while the interest accrued on the deposit comes to 1% p.a. The term of the loan depends on the period of accumulation. If the savings are accumulated during 4 years, the loan is granted for the term of up to 7 years. If the savings are accumulated during the period of 5 years, the term of the loan comes to 10 years. If the accumulation period lasts 7 years, the loan can be granted for the term of up to 15 years. The loan amount can exceed 2.33 times the amount of savings set forth by the agreement.

In order to purchase completed housing with the use of bank loans, the borrower has to pay the downpayment in the amount of 35% of the cost of the housing being purchased. The loan for the remainder of the cost of the housing is granted for the term of up to 30 years at 10.5% p.a., in "OdIn".

The loans granted by the bank can be secured by:

- the housing being purchased, in case of financing of the purchase of completed housing;
- pledge of property rights under the investment agreement, in case of financing of housing construction with subsequent execution of the mortgage agreement on the completed housing.

In addition to this, the bank requires that an insurance policy be taken out on the apartment forming the mortgaged property.

In the period from 1998 till the present, about 3.5 thousand of Ukrainian citizens have been involved into the program of long-term housing financing. The bank has issued loans for the total amount of over UAH 135 mln.

The bank has an interesting practice of issuing mortgage certificates secured by mortgage loans. For this purpose, the bank has founded a subsidiary - Arkada Fund, to which the mortgage assets of the bank were transferred under the assignment agreement. Arkada Fund acts as the issuer of mortgage certificates. The income on the mortgage certificates is calculated in "OdIn". Two issues were performed for the total amounts of UAH 9.2 and 17.5 mln. respectively. The work has started on the third issue for the amount of UAH 52 mln. The mortgage certificates are acquired by investment funds, banks, non-government pension funds, etc.

The techniques employed for issuing mortgage certificates enable the bank to improve the procedures for assignment of loan rights, forming the mortgage loan pools, defining the issue structure and the yield on mortgage bonds, etc.

At the same time, the use of the "OdIn" measurement as a basis for calculating loan payments, interest rates and yield on mortgage certificates raises certain doubts. This instrument is not a market measurement, as it is determined by the bank, based on its own methods. It is calculated on the basis of the official inflation indicators, but the bank reserves the right to take into account other factors as well (i.e. the cost of construction

materials and others). The citizens have limited options for selecting the type and location of the real estate, as the bank issues loans primarily for the purchase of apartments in the houses constructed by Kievgorstroy.

The scheme of share participation of citizens in the construction of housing, which is being implemented by the Arkada Bank, represents a closed cycle, is well developed and guaranteed by the participation of the state holding Kievgorstroï. However, we have to keep in mind that wide dissemination of this scheme can bring negative results as construction risks play too big a role in it. Besides, this scheme is largely dependent on the special position of Kievgorstroy in Kiev, the company's monopoly status, exceptional economic conditions of its operation. All this has to be taken into account when evaluating this scheme of housing financing.

Pursuant to the Law of Ukraine #3044-III "On Conducting the Experiment in House Construction on the Basis of the Kievgorstroy Holding Company" of February 7, 2002, the Arkada Bank acts as the trust manager of the non-government pension fund and children's fund (pension fund under bank management and children's fund under bank management). The experiment is characterized by the following features:

- the funds, contributed by the citizens to the accounts of the non-government pension fund and children's fund, as well as revenues, are exempted from income tax;
- the funds, contributed by legal entities to the accounts of the non-government pension fund and children's fund, are included into the gross expenses of the taxpayer in the amount not exceeding 10% of the gross receipts thereof for the reporting year;
- the money of the non-government pension fund and children's fund are used exclusively for acquisition of mortgage certificates secured by mortgage loans.

3.5.2. Ukrsootsbank

At this time, the bank has started to develop credit financing of natural persons. As the demand for housing loans is growing, this year the bank has started to work with housing loans. The principal scheme used by the bank is financing of the share participation of citizens in the construction of residential houses. The bank implements this program together with Pozniakizhilbut Company. This program is tailored primarily to the high-income families, as it finances the construction of the improved design housing. Another partner of the bank under this program is the Consol construction company, which performs housing construction not only in Kiev, but also in Odessa, the Crimea, Kharkov and other places.

The loans are granted for the term of up to 3 years and secured by the pledge of housing. At the stage of construction, the pledge is represented by the property rights under the investment agreements. The loans are granted primarily in the dollar equivalent. The interest rate on loans is set at 12 - 16% p.a.



Average loan amount comes to USD 7-8 thousand, although there are loans for USD 50 thousand.

The bank has many branches throughout the country and is ready to develop mortgage lending in the regions where the effective demand for mortgage loans is present. According to the estimates of the bank's specialists, the effective demand for housing loans exists in the cities of the Ukrainian South-East, where the metallurgical, chemical and agricultural industries are well developed.

At the same time, the bank experiences lack of long-term resources necessary for implementing big mortgage lending projects.

3.5.3. Privatbank

Privatbank is the leading bank in the development of retail banking, in particular - in the field of consumer financing (purchase of cars, durable goods, etc.) The bank has one of the biggest branch networks.

The bank issues loans to citizens for the purpose of purchasing housing on the secondary market. The bank has agreements with several real estate companies, which check the legality of the transactions on the sale and purchase of real estate. Pursuant to these agreements, the real estate companies undertake to sell the apartment in the event of foreclosure.

The bank mainly uses indirect evaluation methods for the analysis of the borrower's solvency.

The loans are issued for the term of up to 5 years. The loans are granted in USD. Interest rate on the loans is set at 15% p.a.

The loan amount comes to 50% of the cost of the apartment being purchased. Taking into account the market conditions, the bank plans to revise this percentage in the near future and increase it so that LTV will come to 70%. The average loan amount comes to USD 10 - 20 thousand.

Pledge of the housing being purchased serves as security for the loan.

3.5.4. Forum Bank

One of the housing financing programs being implemented by the bank is the program of financing of share participation in construction. The bank finances directly the construction of residential buildings and issues loans to citizens for investment and purchase of the apartments in these buildings.

Under the financing terms, established by the bank, the borrower has to invest 20 - 30% of the cost of the apartment under construction. This constitutes the downpayment. Then, the customer receives a loan for the participation in the construction of housing.

The loan is secured by the property rights under the investment agreement. Upon completion of construction, the apartment is transferred into the property of the borrower and then serves as the security for the loan.

Under this scheme, the most important factor is the trust to the construction company, which implements the construction project, as the construction risks determine the evaluation of this crediting product.

The bank also finances purchasing of completed housing. The borrower has to make the downpayment in the amount of 20 - 30% of the cost of the apartment being purchased. The loan is issued for the remainder of the apartment cost, secured by the pledge of the apartment.

The bank grants loans for the term of 3 to 5 years. The loans are issued in USD. Interest rates on the loans come to 18 - 22% p.a.

The bank experiences problems with long-term resources, attracting the funds for the maximum term of 1 - 1.5 years. In case of financing for longer terms, the problem of balance sheet liquidity arises. This explains the low share of the mortgage loans in the credit portfolio of the bank - no more than 1%.

3.5.5. Oshcadbank

The bank is implementing the housing financing program together with its subsidiary - OOO Oshadzhitlo. OOO Oshadzhitlo is involved in finding customers, selection and appraisal of housing, execution of the sale-purchase agreement, registration thereof, etc.

The bank operates on the secondary real estate market. It has developed its own system of customer analysis, based on the customer's income and collateral. The bank accepts the housing, whether being purchased or existing, as security for the loan.

The loans are granted for the maximum amount of 70% of the cost of the housing being purchased.

The analysis of the borrower's solvency presents a serious problem, according to the bank's specialists, as unofficial income constitutes a considerable portion of the overall income of the population. The bank tries to find individual approach to each customer, there are no uniform standards. When evaluating the borrower's solvency, the bank accepts the share of loan payments at the level of 30 - 50%, and in some cases 66% of the aggregate income of the borrower and co-borrowers. The financing is performed on condition that a guarantee agreement is concluded between the bank, the borrower and the guarantor, who is a member of the borrower's family.

The loans are granted for the term of up to 5 years, the most typical term being 3 years. Although the bank has declared a 15 year term of loan.

The loans are granted in USD at 14% p.a. When the loan is arranged, the borrower pays a commission to OOO Oshadzhitlo for the services provided, in the amount of 1 - 7% of the loan amount.

The average loan amount comes to USD 5 - 15 thousand.

Repayment of the loan and interest payments are performed monthly and calculated by the annuity payments formula. The method of repayment under which the principal amount is repaid in equal installments and the interest is accrued on the remainder of the debt is less frequently used.

Real estate serving as security for the loan is insured with the insurance company selected by the customer. In the future, the bank plans to introduce compulsory insurance of life, health and disability of the borrower.

3.5.6. Aval Bank.

The bank is implementing the "Loan for Housing" program, under which the financing of the housing construction (financing of share participation in construction) and financing of the purchase of housing on the secondary market is performed.

The bank finances investment agreements, as it works with the developing companies on a regular basis. This allows the bank to minimize risks associated with the construction process.

The term of loan is no more than 5 years. The loans are granted in both UAH and USD. The loan amount is set at maximum 70% of the cost of the housing.

Interest on loans is set at the average of 14 - 18% p.a. on the USD loans and 24-25% p.a. on the UAH loans.

The bank uses two repayment schemes for housing loans: annuity payments and repayment of the principal debt amount in equal installments and accrual of interest on the remainder of the debt.

The bank is interested in the development of the mortgage lending, but does not have sufficient resource base for large-scale mortgage lending transactions.

3.6. Non-bank housing financing.

The main role in the financing of housing construction and purchase of housing belongs to the non-bank sources of financing.

As was mentioned earlier, a considerable part of housing construction is financed at the expense of the citizens' funds. According to the expert estimates, about 80-85% of the housing under construction is being purchased at the stage of construction. The citizens' funds are attracted on the basis of investment agreements or as full payment



for the future apartment at the stage of construction. These schemes are used by the majority of residential buildings' developers.

Limited scope of the bank financing determines the dominant role of the non-bank schemes of housing financing.

On the consumer financing market, a certain role belongs to the credit unions, which function in the various regions of Ukraine. At this time, there are 123 credit unions, uniting about 130 thousand people. The credit unions finance only their members with the funds, borrowed from the credit union members in the form of contributions and received from the borrowers of interest payments on previously issued loans.

Credit unions provide mostly the loans for the purchase of consumer goods, as a rule - for short term (up to 1 year). The loans are granted in UAH. Interest rates set on the loans are higher than bank interest rates and come on the average to 25 - 30% or 40% p.a. This can be explained by the high cost of the resources attracted by the credit unions (interest on deposits higher than in banks) and higher financing risk (as the borrower's solvency is not evaluated). At the same time, credit unions have a high percentage of satisfied loan applications. Besides, there are agreements with a number of trading networks, which sell goods for credit unions' loans at a discount. All this makes credit unions attractive for the citizens, especially in the remote areas where they present the only borrowing option.

At this time, credit unions have started to express their interest in housing financing. The loans are issued for small amounts for the purpose of improving the housing conditions. The loan term is from 1 to 1.5 years. The apartment being purchased serves as security.

Development of housing financing as a new service provided by the credit unions can serve as evidence of the growing interest of the population in such loans.

4. Analysis of the Ukrainian Mortgage Regulation and Legislation

4.1. Introduction

This research is devoted to the analysis of the effective and projected legal environment of the Ukraine in the area of residential mortgage lending.

The analysis involved the study of both adopted and drafted regulatory acts and the actual bank practices.

The authors were faced with the complicated task of analyzing a massive bulk of legislative information in a limited period of time. Evidently, an analysis of all regulatory documents relevant for mortgage lending would be unrealistic, while an attempt to cover as many laws and regulations as possible would result in a cursory and shallow review of the issues at hand.

The task was made easier by the availability of expert reviews for some legislative acts. These included the analysis of the role of the registration of real estate rights in the context of the debate on a unified register of encumbrances, including the encumbrances of real estate, securities and other movables;⁶ the analysis of the mortgage law⁷ (this report analyzes a later version which incorporates some comments); the legislation regulating the activities of the *Kyivmiskbud* Holding Company (and, consequently, the *Arkada* Bank).⁸

It should be noted that the authors agree with positions of these reports. Thus, it is possible to avoid multiple repetitions, but to pay more attention to the aspects not deeply addressed in these reports.

At the initial stages of the analysis, it became clear that acute issues for the regulatory framework are very close to those of other post-soviet countries:

- the eviction from residential premises and relations with bodies of trusteeship and guardianship;
- the persistent trend among construction companies and banks to mix construction loans and mortgage loans proper;

⁶ Movable and Immovable Registries: Distinct by Nature. Justin T. Holl Jr., Commercial Law Center, June 19, 2002.

⁷ Steve Butler, Revisions to Ukraine Mortgage Law, September 13, 2002.

⁸ Darrell Brown, Memorandum on the *Law on Amendment of the Law of Ukraine "On Experiments in Residential Construction on the Basis of the Holding Company "Kyivmiskbud"*.

- the general difficulties in exercising the rights to mortgaged property, particularly severe in case of the mortgagor's bankruptcy;
- the difficulties associated with the introduction of traditional self-amortizing loans with variable interest rates;
- structuring relations with the registration system, BTI, and land committees.

Our expectations proved true. Moreover, some new problems were revealed:

- the design of the *Kyivmiskbud- Arkada* experiment, which is based on individual regulatory acts;
- the “three in one” registration system: the attempts to create a unified register of encumbrances for real estate, securities, and, separately, movable property in the background of a typical (also for Russia and the Republic of Kazakhstan) institutional uncertainties in the registration of real estate rights;
- the creation of the Land Bank.

4.2. The Current Status of the Legislation and Bank Practices

At present, the legislative framework for mortgage lending is at the development stage. The Civil Code of the Ukrainian Soviet Socialist Republic⁹ is still in effect, with several amendments and additions. By this time it has probably become a commonplace remark that the code lacks the very concept of “real estate”. Ownership issues not addressed in the Civil Code are governed by the law “On Property”.¹⁰

As regards pledge, the Civil Code¹¹ says that:

“By force of pledge, in case of non-fulfillment of the secured obligation by the borrower (mortgagor) the creditor (mortgagee) shall have the right to satisfaction at the expense of the mortgaged property in priority to other creditors.

The pledge shall arise by force of an agreement or the law.

A pledge may secure a real claim. A pledge may also exist with respect to claims that may arise in the future subject to the availability of an agreement between the parties on the size of collateral securing such claims.

⁹ The Civil Code of the Ukrainian Soviet Socialist Republic, 1963, as amended by decrees of the Presidium of the Supreme Rada of the Ukraine and laws of the Ukraine.

¹⁰ Law of the Ukraine “On Property”, 07/02/1991, No. 697-XI.

¹¹ Article 181, the Civil Code of the Ukrainian Soviet Socialist Republic, 1963, as amended by decrees of the Presidium of the Supreme Rada of the Ukraine and laws of the Ukraine.

The relations of pledge shall be governed by the Law of the Ukraine “On Pledge”, other legislative acts.”

4.2.1. Mortgage: Current Status

The law “On Pledge”¹² specifically devotes several articles to mortgage.

A mortgage contract should be notarized. If provided for by the contract, at the time of certifying the contract the state notary imposes a prohibition on the alienation of the mortgaged property. In the event the contract is certified by a private notary, the state notary will impose the prohibition on the basis of a notice from the private notary about the certification of a contract providing for such prohibition.¹³

It is noteworthy that the prohibition to alienate the mortgaged property is not obligatory, creating opportunities for violations of the right of subsequent mortgagees.

The law also establishes the relation between mortgage of buildings (structures) and of land plots.

Upon mortgage of a building or structure, also mortgaged is the right of use to the land plot occupied by the said objects. In case of foreclosure the acquirer of the building or structure will have the right to acquire the land plot in accordance with the Ukrainian legislation.¹⁴ It should be noted that the right involved is the right to use the land plot.

4.2.2. Current Registration and Notarization Practices

At present, ownership of buildings and structures is registered by the BTI placed in the jurisdiction of the Justice Ministry.¹⁵

Rights to land are registered by the Land Committees. This state of affairs was approved by the resolution of Cabinet.¹⁶

¹² Law of the Ukraine “On Pledge”, as amended by the laws of the Ukraine.

¹³ Article 32. *The Format of a Mortgage Contract*, *ibid.*

¹⁴ Article 9. *Mortgage of Buildings and Structures*, *ibid.*

¹⁵ *On the Approval of temporary Regulations on the Procedure for the Registration of Real Estate Rights*. Order of the Justice Ministry of the Ukraine as of 02/07/2002, No. 7/5.

¹⁶ *On the Measures Concerning the Creation of the System for the Registration of Ownership Rights to Real Estate*. Resolution of the Cabinet of Ministers as of May 16, 2002, No. 661.

This resolution establishes that the state register of ownership rights to real estate, except land plots, is to be held by the Justice Ministry, and the state register of lands – by the State Committee for Land Resources.

In accordance with the conciliated decision of the Justice Ministry and the State Committee for Land Resources, the state register of ownership rights to real estate includes a data base on land ownership, the right of perpetual use of land, and land leases, and, respectively, a data base on real estate objects is being created in the state register of lands.

Data on the right of ownership to land, right of perpetual use, land leases, and the right of ownership to real estate are provided to the appropriate state registers in the procedure established by the Justice Ministry and the State Committee for Land Resources.

A contract for sale/purchase of real estate is subject to notarization. The fee charged for the notarization equals 1 percent of the transaction price.^{17 18}

Mortgage contracts are also subject to certification by a notary, who introduces a prohibition to alienate the property into the national register, *Prohibitions on the Alienation of Real Estate*, kept by the Justice Ministry. The fee charged for the notarization equals 0.1 percent of the value of the mortgaged property.

4.2.3. Use of Financial Instruments

Two problems faced by the banks in their practical operations may be identified:

- opportunities for using various financial instruments;
- the likelihood of artificially prolonged procedures for foreclosing on the mortgaged property and evicting the occupants.

Formally, the current legislation does not permit lending in foreign currency and leaves nearly no opportunities for using variable rate loans.

Loans in the U.S. dollars may be extended to natural persons, but only through the system of credit cards, as provided by Item 10 of the Regulations of the National Bank of the Ukraine:¹⁹

“Loans in foreign currency shall be extended to resident legal entities, resident natural persons engaged in entrepreneurial activities, residents for operations carried out with

¹⁷ On State Duty, decree of the Cabinet of Ministers of the Ukraine as of January 21, 1993, No. 7-93.

¹⁸ Note that sale/purchase transactions with real estate are subject to a tax to the Pension Fund in the amount of 1 percent of the transaction price.

¹⁹ On Lending, Regulations of the NBU approved by the Board of the National Bank of the Ukraine, September 28, 1995, No. 246.

the use of international payment cards, and non-resident legal entities – bank institutions”.

Commercial purposes of lending are here very clearly underlined.

Pursuant to the decree of the Cabinet of Ministers of the Ukraine No. 15-93 as of 02/19/93, *On the System of Currency Regulation and Currency Control* (Subitem “c” of Item 4 of Article 5), *“an individual license shall be required for operations of extending and obtaining loans in foreign currency by residents if the terms and amounts of such loans exceeded the limits established by the legislation”*.

At the same time, pursuant to the letter signed by S. Bragin, director of the Department for Currency Control and Licensing of the National bank of the Ukraine (No. 28-313/2178 as of 05/29/01:

“At this time, no requirements or restrictions are established by the effective law on the maximum size and terms of loans in foreign currency attracted or extended to residents in the Ukraine, and thus operations for obtaining or extending loans in foreign currency carried out by residents do not require an individual license of the National Bank of the Ukraine”.

The national bank of the Ukraine registers agreements providing for debt obligations of residents to non-residents (decree of the President of the Ukraine, No. 734/99 as of 06/27/99).

Pursuant to the Regulations on issue of payment cards and operations with these cards approved by the Board of the National Bank of the Ukraine (No, 367 as of 08/27/01, Item 4.7):

“The extending of credit (including overdrafts) for carrying out operations with the use of plastic cards shall be carried out with account for the restrictions established by the regulatory legal acts of the national bank of the Ukraine for on lending issues, as well as other regulatory legal acts of the National Bank of the Ukraine”.

However, taking advantage of the vague interpretation of the regulatory acts of the national Bank of the Ukraine, commercial banks issue home purchase loans to natural persons in U.S. dollars, introducing limits on credit cards or overdrafts on debit cards secured by mortgage of real properties (mostly apartments) based on various schemes for the order of priority of operations and actions.

In the opinion of the experts we contacted, the National Bank of the Ukraine is fully aware of the situation but refrains from taking any steps to prohibit such operations or to amend its regulatory acts.

The law has no specific provisions regarding loans in which the principal debt is tied to the U.S. dollar exchange rate or some other index, but no prohibition is in place. As reported by several experts, this has not found broad acceptance among the Ukrainian banks, except for the one but highly important case – a special settlement unit, *Odln*, of the Arkada Bank, defined as follows:

“Odln” shall mean an indexing conventional settlement unit, which is established by an authorized bank on the basis of its own methods taking into account the inflation index, the index of prices of industrial producers, the index of the prices for construction work and other indices as the bank chooses and which influence definition of the value of the mortgage obligations.”²⁰

As regards lending to private individuals and legal entities with the use of variable interest rate instruments, there is no legislative prohibition to provide for interest rate adjustments in a loan contract. However, in essence it is treated as modification of a material provision of a contract – the price of the loan.²¹

Parties to the loan contract may provide for interest rate adjustments when signing the contract or later by way of additional agreements. The interest rate may be raised or lowered depending on the borrower’s behavior during the life of the loan and the financial capacity of the lender.

The following example from an actual loan contract may be appropriate here: “The interest rate under the present Loan Contract shall be subject to adjustments by mutual agreement between both parties in cases of changes in the cost of credit resources on the financial markets, as well as changes in the discount rate of the National Bank of the Ukraine.” The contract provides for the procedure for rate adjustments, which may also include acceleration of the loan principal and interest if the borrower disagrees with a new (higher) interest rate. Therefore, everything depends on the way the loan conditions are formulated in the contract with regard to the main principle of contractual relations, the mutual agreement of the parties.

In our opinion, this language is essentially a factual change in the material provisions. When we talk of variable interest rates, we mean, a formula close to the one given below, which synonymously defines it’s amount:

“the interest rate shall be defined as profitability of government securities (of a specified issue) plus four percentage points”.

The individual legislative acts providing legal grounds for the activities of the *Arkada Bank*²² do not pose any problems from the viewpoint of legal analysis, but an economic analysis of the efficiency of the decision-making is an issue.

²⁰ The Law of the Ukraine “On Experiments in Residential Construction on the Basis of the Holding Company “Kyivmiskbud””.

²¹ Explanations of the Supreme Economic Court as of 10/06/94, No. 02-5/706.

²² The Law of the Ukraine “On Experiments in Residential Construction on the Basis of the Holding Company “Kyivmiskbud””.

The Law of the Ukraine “On Amendment of Certain Legislative Acts of the Ukraine Following the Adoption of the Law of the Ukraine “On Amendment of the Law of the Ukraine “On Experiments in Residential Construction on the Basis of the Holding Company “Kyivmiskbud””.

4.2.4. Foreclosure and Eviction

The provisions of the law “On Pledge” should agree with those of the laws on the state marshals’ service²³ and on foreclosure procedures²⁴. However, several provisions allow for different interpretation.

The law on executive procedures provides that executive procedures shall be suspended without fail in a number of cases:

- “- when the claimant or borrower is recognized as incapacitated;
- when the debtor contests the writ of execution in a court procedure lacking the required capacity, if permitted by the law;
- when an appeal against the actions of official bodies (persons) has been received by the bodies authorized to review cases of administrative violations;
- when a resolution suspending the execution of respective decision has been taken by an official who has such right by force of law;
- if a court suit has been filed for a withdrawal from the list of attached property.”²⁵

As one can easily see from the above, the list of grounds is rather extensive, creating the likelihood of a protracted foreclosure process.

Certain uncertainties are added by the established order of priority for satisfying the claims.

“In the event the sum claimed from the borrower is insufficient for satisfying all claims under writs of execution, this sum shall be allocated among the claimants by the state executor in the following order of priority.

In the first turn, satisfied shall be claims related to alimony, compensation for losses caused by a trauma or other damage to health, as well as those related to the loss of the bread-winner and claims secured by pledge for satisfaction at the expense of the mortgaged property.”²⁶

Therefore, pledge is not intended to secure the priority satisfaction of mortgagee’s claims.

²³ The law “On State Marshals’ Service”, 03/24/1998.

²⁴ The law “On Executive Procedures”, 04/21/1999.

²⁵ Article 34. *Circumstances Predetermining Mandatory Suspension of Execution*, *ibid*.

²⁶ Article 44. *Priority for Satisfying Claims*, *ibid*.

The claims of claimants of each subsequent turn are satisfied only after the preceding claims have been satisfied in full. In the event the total sum claimed is inadequate for satisfying all claims of one level of priority, the claims are satisfied in proportion to the sums due to each claimant.

Sums collected from the debtor which are subject to transfer to the claimants are placed by the state marshal in a special deposit account of the appropriate unit of the State Marshal Service and are provided to the claimants in the established procedure.

Foreclosure on the debtor's property consists in its attachment, withdrawal and forced realization.

Pursuant to Article 50,²⁷ foreclosure under a writ of execution is carried out, in the first turn, with respect to debtor's funds in hryvna and foreign currency, and other valuables, including debtor's accounts and deposits in banks and other credit institutions, and accounts in depositaries of security papers.

"Ready cash found in the possession of the borrower is withdrawn.

If data are available on money and other valuables in accounts and deposits in banks or other credit organizations, they are attached.

In the event the debtor lack the funds and valuables sufficient for satisfying the claims, the claims are satisfied from the value of other property of the debtor, with the exception of the property for which foreclosure is not permitted by the law. The debtor shall have the right to indicate the type of property or articles to be foreclosed on in the first turn."²⁸

Of special note is the last sentence: if a debtor has the right to select the type of property to be foreclosed on, the ideological consistency of pledge relations is destroyed.

The final decision on the order of priority in foreclosure proceedings is placed with the state marshal.

The foreclosure on the property of the debtor is executed in the amount and volume required to enforce the writ of execution, including the execution costs. In the event the borrower owns the property jointly with other parties, the foreclosure is executed with respect to the portion of the property determined by the courts at the request of the state marshal.²⁹

Still more doubtful are the foreclosure procedures for satisfying the mortgagee's claims envisaged in Article 50.

²⁷ Article 50. *Procedures for Foreclosing on the Funds and Other Property of the Debtor*, *ibid.*

²⁸ *Ibid.*

²⁹ *Ibid.*

“Foreclosure on the mortgaged property by way of forced execution shall be permissible both for satisfying the claims of the mortgagee, and for satisfying the claims of other claimants.

For satisfying the claims of a mortgagee, the foreclosure is executed with respect to the mortgaged property of the debtor if other property of the debtor is insufficient for satisfying these claims in full, subject to compliance with the rights of the mortgagee established by the legislation.”³⁰

Article 64, *Foreclosure on Other Property of a Corporate Borrower*, establishes the order of priority upon foreclosure.

In the event a borrower who is a legal entity lacks the funds to cover the entire debt, the claims are satisfied from the value of other property. This property is attached and realized in the following order of priority:

- “1) in the first turn – the property directly used for production (securities, deposits and other accounts of the borrower, currency valuables, auto transportation vehicles, office design articles, and other property);
- 2) in the second turn – finished products (goods), as well as other valuables not used in production;
- 3) in the third turn – real estate objects, machine tools, equipment, other fixed assets, as well as raw materials intended for the production process.”

Thus real estate is once again removed to some “third turn”, while for normal operations of the mortgage system it would be desirable to eliminate every ambiguity in the legislative provisions.

Obviously, at present the issue of borrower’s evicting upon foreclosure on an apartment has no adequate solution. Interviews with representatives of the banking community revealed problems arising upon foreclosure on residential units occupied by parents with children. The problem is well known in the Republic of Kazakhstan and Russia, and will probably require substantial time and changes in the court practices. The draft Mortgage Law contains convincing provisions for this situation. However, as proven by Russia’s experience, the problem may not be addressed by legislative provisions alone.

The eviction procedures are governed by Article 79, *Enforcement of the Decision to Evict the Debtor*.³¹

The eviction decision is enforced if the debtor fails to vacate the apartment within the term established by the state marshal (15 days), set force for vacating the premises voluntary.

³⁰ Article 52. *Foreclosure on the Mortgaged Property*, *ibid*.

³¹ *Ibid*.

The eviction consists in vacating the premises identified in the writ of execution from the person (persons) being evicted, their property, and in prohibiting such person (persons) to use the premises.

“The state marshal is obliged to provide written notice to the debtor on the date and time of forced eviction. If informed about the date and time of the eviction, the absence of the debtor shall not be regarded as grounds preventing the enforcement of the decision.

The eviction shall be carried out in the presence of witnesses with the assistance of the bodies of internal affairs and mandatory inventory of the property by the state marshal. One copy of the property inventory act shall be provided to the debtor against receipt. Whenever necessary, the state marshal shall ensure the safe-keeping of the debtor's property, but for not more than three years, placing the costs incurred on the borrower. At the end of three years, any unclaimed property shall be realized in the procedure provided for the realization of abandoned property.

In the event the enforcement takes place in the absence of persons subject to eviction, the state marshal shall be obliged to obtain an assessment of the property along with its inventory. The inventoried property shall be placed in the custody of a party appointed the custodian of the property by the state marshal.

The enforcement of the decision to evict the borrower shall be documented by the state marshal in an act signed by all parties participating in the enforcement.”³²

It is supposed that the court may take the decision that a person subject to eviction should be provided with another premises, the state marshal notifies the appropriate housing or other authority with a notice on the term in which the premises should be provided. In case of failure to provide a unit within the established term, the state marshal may execute and appropriate act and apply to the courts for a decision on further steps for implementing the decision. Once the suit is accepted by the court, the executive proceedings are suspended.

Upon the origination of circumstances which obstruct the enforcement of the decision or make such enforcement impossible, the state marshal passes a resolution on the suspension or termination of executive proceedings, respectively.

4.2.5. Specific Features of Foreclosure upon Bankruptcy of the Mortgagor

Pursuant to Article 11, *On the Initiation of a Bankruptcy Case*,³³ the judge who has accepted a bankruptcy the case shall not later than within five days .issue and forward

³² Ibid.

³³ Law of the Ukraine, *On Reconstructing a Borrower's Paying Capacity or Recognizing It as Bankrupt*, as of March 7, 2002.

to the parties and the state body for bankruptcy issues a resolution on the acceptance of the case for review, which contains a statement that the case has been accepted for review, procedures for the disposition of the debtor's property established, trust manager appointed, the date of a preliminary session of the court, which should be held not later than the thirtieth day from the date the case is accepted for review, unless provided otherwise by this law, and the introduction of a moratorium on creditors' claims.³⁴

Article 12 of the law, *Creditors' Claims and Moratorium on Creditors' Claims*, establishes the following procedures for the moratorium.

An economic court takes the decisions ensuring the satisfaction of creditors' claims at the appeal of the participants of the bankruptcy case or at its own initiative.

An economic court, at the appeal of the property manager, creditors, or at its own initiative may prohibit transactions that do not have the consent of the arbitration manager, or obligate the debtor to transfer securities, currency valuables, and other property into the custody of third parties, or take other measures ensuring the preservation of the property, subject to the enactment of the respective resolution.

The moratorium on creditors' claims is introduced at the time the bankruptcy case is accepted for review, for which an appropriate resolution is passed by the economic court.

During the moratorium on creditors' claims:

- it is prohibited to execute foreclosure on the basis of a writ of execution or other document stipulated by the law;
- no late fee or penalty may be charged, and no other sanctions imposed for the non-fulfillment or improper fulfillment of the monetary obligations and tax obligations (obligatory payments).

Therefore, the satisfaction of mortgagee's claims is suspended till the completion of the bankruptcy proceedings, as will be shown below.

Pursuant to Article 22, *Resolution Recognizing the Debtor Bankrupt and the Opening of the Liquidation Proceedings*, in cases provided by the law,³⁵ the economic court adopts the resolution recognizing the debtor as bankrupt and opens the liquidation proceedings.

The term of the liquidation proceedings may not exceed twelve months. However, an economic court may extend it for six months. Therefore, the legislation provides for the possibility to delay actual foreclosure for eighteen months.

³⁴ Ibid.

³⁵ Law of the Ukraine, *On Reconstructing a Borrower's Paying Capacity or Recognizing It as Bankrupt*.

Pursuant to Article 26, *Liquidated Estate*,³⁶ all assets (property and property rights) of the bankrupt held by right of ownership or full economic jurisdictions as of the date of the opening of the liquidation proceedings or revealed in the course of the liquidation proceedings are included into the liquidated estate, with the exception of state housing stock, including dormitories, pre-school facilities, utility infrastructure, which upon the bankruptcy of the enterprise are conveyed to appropriate local communities in the procedure established by the law without any additional conditions and are financed in the established procedure.

The bankrupt's property encumbered by a mortgage is included into the liquidation estate for use exclusively for the priority satisfaction of the mortgagee.

The last paragraph gives grounds for hope that the claims of the mortgagee will be fully satisfied, albeit with long delays. However, Article 31, *Priority of Creditors' Claims*,³⁷ proves the contrary. This article says that receipts from sale of a bankrupt's property shall be used to satisfy the following claims simultaneously:

- “a) claims secured by a pledge;
- b) severance fee for the bankrupt's employees;
- c) expenditures from the Guarantee Fund for deposits of natural persons related to these persons' right of a creditor of the bank, in the amount of compensation for deposits of natural persons;
- d) costs of the bankruptcy proceedings in the courts and the liquidation commission, including:
 - state fee;
 - applicant's costs of publishing a notice on the bankruptcy case;
 - the cost of an official publication of the information on the sale of the bankruptcy estate;
 - the cost of a mass media publication of the information on the initiation of the bankruptcy proceedings in the event an amicable agreement is deemed null and void;
 - expenditures of the arbitration manager (trust manager, receiver, liquidator), related to the maintenance and safe-keeping the the bankrupt's property assets;
 - creditor's expenditures for an audit, if such audit is conducted at their expense by decision of the economic court;
 - labor remuneration of arbitration managers (trust managers, receivers, liquidators).”

³⁶ Ibid.

³⁷ Ibid.

Therefore, priority satisfaction is granted to a substantial number of creditors other than the mortgagee. Consider just the impact of individual depositors in banks as priority creditors.

4.3. Evaluation of the Efficiency of the Legislation Drafted

The incompleteness of the current legislative framework is generally recognized. Moreover, the conceptual basis for further legislative activities has been established by a presidential decree.³⁸ Part 1 of the Decree defines the priorities in organizing a mortgage market in the Ukraine:

- “the formation of the legislative and regulatory framework on hypothecation which will enable to effectively use mortgage as an additional source for attracting funds for addressing the socio-economic issues;
- the creation of the system of guarantees and of a transparent environment for the mortgage/hypothec market participants, first of all through the introduction of an effective system of state registration of real estate rights, standardization of activities on the mortgage market, and establishment of mechanisms for insuring mortgage loans;
- establishing types of mortgage securities, establishing the procedure for issuing them and their circulation, ensuring the proper control over their circulation.”

Regretfully, these measures do not include the adoption of a new Civil Code, which in the opinion of the authors of this report may seriously impede legislative development in the area under review. At the same time, priority attention is given to the issue of mortgage securities.

The above mentioned decree also contains a comprehensive list of legislative acts that need to be drafted and submitted to the Supreme Rada of the Ukraine.

The decree envisages improvement of the existing or development of new regulatory provisions for the following areas:

- «The grounds (basis) for appearance of hypothec/mortgage and demand/claim secured by it;
- A list of property and property rights, including the right to lease a land parcel, that may be the subject of mortgage;
- The procedure for state registration of hypothec/mortgage and the body that will perform such registration;
- Types of mortgage backed securities, the procedure for issuing them and their circulation, the rights of owners of mortgage securities;

³⁸ Decree of the President of the Ukraine, *On Measures Related to Developing Mortgage (Hypothecation) Market in the Ukraine*, as of August 8, 2002.

- Regulation of issues of mortgage lending;
- The procedure for taxing the transactions with mortgage backed securities, transactions related to construction or acquisition of housing at the expense of mortgage loans;
- The procedure for safekeeping of immovable property pledged under mortgage contract, for transferring rights to such property;
- Specific features of mortgage of specific types of property;
- The procedure for foreclosure and the sale of property which is the subject of mortgage».

Specific provisions are made for the activities of the National Bank and Securities Commission, who are assigned with the development of the following regulatory acts:

- «The procedure for introducing land mortgage, enlarging the range of persons that may be a land mortgagee, appraisal of land, state land cadastre;
- Introducing into laws on banking and insurance activity, activity on stock market and other financial markets the changes and amendments related to the development of mortgage loans, establishing specifically the procedure for the refinancing of mortgage loans, mechanisms for insuring mortgage loans, the procedure and terms for issuing and floating securities and their derivatives on the mortgage markets, mechanisms for using mortgage backed securities for the purposes of pension provision».

In the opinion of the authors of this report, the key laws determining the development of the mortgage market in the Ukraine in the near future will be:

- the new Civil Code;
- the Mortgage Law;
- the Registration Law.

On the whole, the mortgage system also calls for the improvement of the tax law, the laws On bankruptcy, On Executive proceedings, On Banks and Banking Activities, as well as many other legislative and regulatory acts, including, first of all, the regulatory acts of the National Bank of the Ukraine.

At a certain phase (after the problems in the organization of the primary mortgage market, i.e., the origination of mortgage loans for home purchases are successfully addressed), the law on mortgage securities will become an important task.

4.3.1. Analysis of the New Draft of the Civil Code³⁹

The draft Civil Code creates the foundations for mortgage in Article 577, defining it as follows:

“Mortgage shall be a pledge of real estate which remains in the possession of the mortgagor or a third party”.

Noteworthy, the same article provides that the rules for a land mortgage or for other types of pledge shall be established by the law. However, as shall be demonstrated later, the draft Mortgage Law lacks specific provisions for mortgage of land plots and residential units, which, in our opinion, is a shortcoming that is at conflict with the draft Civil Code.

One of the issues that call for a detailed analysis is the procedures for satisfying creditors' claims⁴⁰ and the priority of mortgagee's claims⁴¹.

The draft Civil Code (Article 112) provides that upon the liquidation of an insolvent legal entity the creditors' claims will be satisfied in the following order of priority:

1. in the first turn, claims for damages to health and life and creditors' claims secured by a pledge or other instruments;
2. in the second turn, claims of employees associated with labor relations, author's claims for remuneration for use of intellectual property;
3. in the third turn, claims associated with the payment of taxes and fees (obligatory payments);
4. in the fourth turn, any other claims.

Pursuant to Article 574, the mortgagee's rights are secured by the fact that by force of the law the creditor (mortgagee) has the right in case of non-fulfillment by the debtor (mortgagor) of a mortgage-secured obligation to satisfy his claims from the value of the mortgaged property in priority to the creditors of the debtor, unless otherwise established by the law (right of pledge).

Which of these Articles will be applied with respect to mortgagee's rights upon the liquidation of an insolvent legal entity is difficult to foresee. However, the most acceptable wording would be the one that excludes any competition between the mortgage and “other instruments” of securing an obligation.

³⁹ The Civil Code of the Ukraine, draft as of 02/07/2002.

⁴⁰ Article 112, the Civil Code of the Ukraine, draft as of 02/07/2002.

⁴¹ Ibid, Article 574.

4.3.2. Registration of Transactions. The Relation of Registration and Notarization, Origination of a Right

Article 183, State Registration of Real estate Rights, provides that ownership and other real rights to real estate, restrictions of these rights, their origination, transfer and termination shall be subject to state registration.

The state registration of real estate rights and transactions shall be public and shall be performed by the appropriate agency that is obliged to provide information on the registration and registered rights in the procedure established by the law.

A denial of the state registration of a right to real estate or of a transaction with it, evasion of the registration, refusal to provide registration data may be appealed in the courts.

The procedures for the state registration of rights to real estate and grounds for denying the registration shall be established by the law.

The above gives rise to the question which has been the subject of discussions discussed in Russia for several years, "What should be registered: rights, transactions, or both?" In the event both rights and transactions are subject to the registration, it will be necessary to define the status and legal implications of the registration of transactions. Regardless of the answer to this question, the above definition creates confusion about the subject of the registration by requiring the registration for the rights, transfer of rights, origination of rights, and termination of rights.

The procedures for notary certification of transactions are set forth in Article 210.

Transactions executed in writing shall be subject to notarization only in cases provided for by the law or agreement between the parties.

The notarization may be performed by a notary or any other official authorized to do so in accordance with the law, by making a notation on the document describing the transaction.

Any transaction may be notarized at the request of a party to the transaction (a private individual or legal entity).

Some contradictions may be revealed if these provisions are compared to the provisions of another article of the draft Civil Code - Article 336, *The Moment of Acquiring Ownership Right under a Contract*.

Pursuant to this article, the right of ownership of an acquirer under a contract arises from the time of transfer of the property unless otherwise provided for by the contract or law.

The right of ownership under a contract subject to notarization arises from the time of notarization or from the coming into force of a court judgment recognizing a non-notarized contract as valid.

In the event a contract on alienation of the property is subject to state registration, the right of ownership of the property by the acquirer arises from the time of such registration.

Does this all mean that with the enactment of the new Civil Code transactions with real estate will no longer require notarization?

The second question is, does the law-maker mean that in this case the right of ownership will be originated with the registration of the transaction. The latter assumption is open for discussion.

The above considerations become important in the light of Article 659, *Format of Selected Types of Sale/Purchase Agreements*, which provides that contracts for purchase of a land plot, a unified property complex, a residential building (apartment) or other real estate should be executed in writing and are subject to notarization and state registration.

4.3.3. The Relation Between the Origination of Mortgage and State Registration

For the issues under review, it is particularly important to establish the relation between the origination of ownership right and mortgage and the registration in the State Register of Rights and Encumbrances, if such register were created.

The draft Civil Code provides that the right of pledge originates at the time of concluding the contract, and in case when the contract is subject to notarization from the time of such notarization.⁴² However, a mortgage becomes known to third parties only if reflected in the unified state register of rights, and thus for a mortgage contract it is preferable to make it valid for third parties from the time of state registration of the mortgage as an encumbrance.

4.3.4. Opportunities for use of Financial Instruments with Variable Interest Rates

Article 1067 of the draft Civil Code, *Interest on Loan Contracts*, says that ‘a lender shall have the right to obtain from the borrower interest on the amount of the loan unless established otherwise by the contract or the law. The amount and procedure for paying interest shall be established by the contract. If the size of interest payment is not determined in the contract, its size shall be established as the discount rate of the National Bank of the Ukraine.’

In turn, Article 1073, *Credit Contract*, says that “under a credit contract the bank or other financial institution (creditor) assumes the obligation to provide cash (credit) to the borrower in the amount and under the conditions established by the contract, while the

⁴² Ibid, Article 587, *The Moment of the Origination of Pledge*.

borrower assumes the obligation to repay the credit and pay interest”.⁴³ In order to eliminate ambiguities about the possibility of variable rate mortgages it would be reasonable to use the language given, for example, in the draft Mortgage Law:

“A mortgage agreement shall contain the following important terms: ... - contents of the main obligation, amount of the main obligation or the formula for the determination of the amount of the main obligation and rate at any time, term and procedure for its performance’.

4.3.5. Protection of Bona Fide Purchasers of Real Estate Registered in the State Register of Rights (SRR)

Article 332 of the draft Civil Code, *Ownership Right of a Bona Fide Purchaser of the Property Alienated by a Person Who Did Not have the Right to Do It*, establishes grounds for the acquisition of ownership rights:

“In case the property was alienated by a person who did not have the right to do so, a bona fide purchaser shall acquire ownership right to the property if pursuant to Article 390 of this Code the property may not be claimed from him”.

Article 390 of the draft Civil Code, *Owner’s Right to Claim the property from a Bona Fide Purchaser*, proposes the following.

In the event the property was acquired under a contract for pay from a person who did not have the right to alienate it, of which the purchaser did not know and could not have known (a bona fide purchaser), the owner has the right to claim the property only if the property:

- 1) “was lost by the owner or the person to whom the owner conveyed the property;
- 2) was stolen from the owner or the person to whom the owner conveyed the property;
- 3) was removed from the possession of the owner or the person to whom the owner conveyed the property in some other manner without their consent.

The property may not be claimed from a bona fide purchaser if sold in the procedure established for the enforcement of court decisions.

If the property was acquired from a person who did not have the right to alienate it, the owner shall have the right to claim it from the bona fide acquirer in all cases.”

These articles do not even mention real estate or the system of state registration of real estate rights. However, protection of real estate owners whose rights are registered in the state register of rights and who relied on the data of the register and acted as bona

⁴³ The Civil Code of the Ukraine, draft dated 02/07/2002.

fide purchasers in the transaction with it is of great importance for the transfer of real estate and, consequently, for the mortgage lending system.

4.3.6. Analysis of the Draft Mortgage Law⁴⁴

In itself, the draft Mortgage Law represents a well-drafted document and thus the comments and proposals to it are supplementary with respect to the comments provided by S. Butler.⁴⁵ It should also be noted that this report relies on a later version of the draft.

First of all, in our opinion, the law lacks “particular parts”:

- Specific features of the mortgage of land plots.
- Specific features of the mortgage of residential buildings and apartments.

First, these sections are required to reflect the high specificity of respective transactions; and, second, similar provisions have been made in the draft of the new Civil Code.

The issue of which law – the Mortgage Law or the Registration Law – should describe the specific features of state registration of a mortgage may be debated, but the need to have a special section for addressing this issue does not raise any serious doubts.

Let us now turn to the comments to particular provisions.

1. Article 3. Occurrence and Application of Mortgage

A mortgage arises by an agreement or law as of the date of its state registration in the respective registry of encumbrances.

This Article should probably speak about the state register of rights in accordance with the law on the registration of real estate rights.

The time a mortgage originates by force of law is a complicated issue, as essentially a mortgage by force of law originates after the registration of the ownership right.

2. Article 4. Subject of Mortgage

Only the immoveable property registered in the respective state registry of immoveable property, and also the objects of incomplete construction, may be subject to mortgage.

This Article should probably speak about the registration of rights, rather than the registration of real estate objects per se.

⁴⁴ Law of the Ukraine, *On Mortgage*, draft dated October 1, 2002.

⁴⁵ Steve Butler, *Revisions to Ukraine Mortgage Law*, September 13, 2002.

3. Article 14. Mortgage of Land Parcels

Unless otherwise provided by law or the mortgage agreement, a land parcel and all objects inseparably linked thereto so that their displacement without disproportionate damage to their designated purpose is impossible shall be mortgaged as a single whole.

Objects constructed by the mortgagor or any other person on the mortgaged land parcel after conclusion of a mortgage agreement shall become the subject of mortgage, unless otherwise provided by the mortgage agreement.

This is a most progressive approach, consistently introducing the concept of a unified real estate object. Noteworthy, unlike the Russian Civil Code, the draft Civil Code of the Ukraine duly honors this concept.

However, to introduce mortgage of buildings and structures within the shortest time possible, it may be necessary to provide for mortgage of the lease rights to a land plot, as a substantial portion of the land is not held in private ownership.

4. Article 17. Mortgage Agreement

A mortgage agreement shall be concluded between the mortgagor and the mortgagee pursuant to the requirements of this Law in writing and shall be subject to notarization. A mortgage agreement shall contain the following important terms:

- contents of the main obligation, amount of the main obligation or the formula for the determination of the amount of the main obligation at any time, term and procedure for its performance;

As reviewed above, this provision should be reflected in the new Civil Code. However, it would be reasonable to specify that the formula may be applied to both loan principal and interest. (The use of variable interest rates was discussed in Section 4.3.4.)

5. Article 18. State Registration of Mortgage

A mortgage shall be subject to state registration in the relevant registry according to the procedure established by law.

In our opinion, the Article should specifically refer to the registration law.

6. Article 19. Amendments to the Mortgage Agreement

Changes and amendments to a mortgage agreement shall require notarization and state registration according to the procedure established by law.

Overall, notarization of a mortgage contract becomes questionable with the introduction of a fully-fledged system for the registration of real estate rights. This was already discussed in the section on the Civil Code.

If the main obligation is subject to performance in parts, the holder of the mortgage bond is obligated to provide the mortgagor with written receipts of payment and to maintain an appropriate schedule of payments on the bond,

which schedule shall be provided to the mortgagor on demand. In the event of a conflict between the receipts for payment and the schedule of payments attached to the mortgage bond the receipts for payment shall prevail.

It would be reasonable to establish a flexible procedure for stating the information on the performance of the obligation under a loan contract in parts. Specific provisions should be made about what supporting documents may be used, and how often the borrower can make notations on the Zakladnaya.

7. *Article 24. Assignment of Rights by a Mortgagor under a Mortgage Agreement*

Assignment of mortgagee's rights under a mortgage agreement shall not require mortgagor's consent, unless otherwise provided by a mortgage agreement, and provided that rights on the main obligation are assigned simultaneously.

It would be reasonable to provide for the obligation to inform the debtor about the transfer of lender's rights to another party.

8. *Article 29. Grounds for Imposing Seizure on the Subject of Mortgage*

A mortgagee shall have the right to satisfy his/her claims from the value of the subject of mortgage by imposing seizure to the subject of mortgage in the event of debtor's default on the obligation secured by a mortgage, or inappropriate performance of thereof, within the period specified by the obligation, unless otherwise provided by law or the agreement.

Overall, the draft appears not to include (e.g., judging by the volume of funds) the main instrument – a self-amortizing housing mortgage loan. It would probably be feasible to introduce, for example, three payment delays within a year as the grounds for foreclosure on home mortgages.

9. *Article 32. Mortgagee's Right to Sell the Property that is Subject of Mortgage*

In case of selling the subject of mortgage by way of concluding a purchase-and-sale agreement, the sale price of the subject of mortgage must be determined upon the agreement between the mortgagor and the mortgagee, or based on the independent evaluation, at the level not lower than usual market prices. If this requirement is not met, the mortgagee shall be liable to the mortgagor for reimbursement of the difference between the sale price of the subject of mortgage and the usual market price thereof.

Some clarification is necessary. If the property is sold, why should one hold an unsecured claim?

10. *Article 33. Disposal of the Subject of Mortgage by Court Decision*

The court may refuse to satisfy the mortgagee's action on premature seizure of the subject of mortgage provided that breach of the main obligation committed by the debtor or the mortgagee causes no losses to the mortgagee.

The law should provide clearer grounds for foreclosure specifically for the purpose of establishing clear relations between the lender and the borrower prior to court settlement.

The initial sale price for the subject of mortgage shall be determined at the mortgagor's and the mortgagee's agreement, and if they failed to reach the agreement – by the specialized organization. The initial price may not be below 90 percent of its market value, determined through independent valuation.

The first sentence provides no information because essentially everything depends on a licensed appraiser.

11. Article 38. Procedure for Holding Public Auctions

A lot shall be put up for bid in the presence of at least one bidder. In case only one bidder is present at a public auction, the property may be purchased by him only at its initial price.

In our opinion, at least two bidders should be required so as not to render meaningless the very concept of an “auction”.

12. Article 42. Mortgagee's Rights and Obligations Where a Public Auction is Recognized as Invalid

Should the mortgagee fail to exercise his/her right, provided for by part one of this Article by the results of the first public auction, holding of the second public auction shall be appointed, which shall take place within one month after holding the first public auction on the same terms.

It is probably necessary to provide for the procedure for lowering the price for the second auction.

4.3.7. Draft Registration Law⁴⁶

The draft Registration Law, same as the draft Mortgage Law, lacks particular provisions for a condominium, common ownership, newly created real estate object, mortgage, and others.

The draft law also fails to give clear definitions of the recordation and registration functions.

Article 10, System of Bodies for the State Registration of Rights, of the draft says:

⁴⁶ Law of the Ukraine, *On State Registration of Rights to Real Estate Objects*, passed in the first reading on May 14, 2002.

“The system of bodies for the state registration of ownership right to real estate objects shall include:

- State Committee for Construction, Architecture and Housing Policy of the Ukraine;
- territorial (district in rural districts, and city) bodies for the state registration of real estate rights;
- qualification board of the state registrars of rights;
- archives of the bodies for state registration of rights.”

Therefore, records of the state registration of rights will be maintained by the State Committee for Construction, Architecture and Housing Policy of the Ukraine. In this case special care should be taken to define the relations between the Justice Ministry and bodies assigned with the recordation and management of land resources.

Article 2, *Terms and Definitions*, of the draft law says that state registration of rights to real estate (state registration of rights) entails actions for introducing data into the State Registry of Rights on the rights to a real estate object, its owner, as well as on the origination, restriction, and termination of rights thereto.

Probably, it should be stressed that the state registration of real estate rights is an act of confirmation of these rights by the state, while “actions for introducing data” is a neutral, purely informative provision.

Article 4, *Rights Subject to State Registration*, says that state registration shall be required for the right of ownership to real estate objects, the right of full economic jurisdiction, operative management of these objects, and other such rights (ownership rights) to real estate, unless provided otherwise by the Law. In cases provided for by the legislation, state registration shall be required for the rights of use and other rights to real estate objects. This Article should be reconciled with, for example, Article 397, *Types of Real Rights to Other's Property*, of the draft Civil Code that envisages the following rights:

- “1) the right of possession;
- 2) the right of use (servitude);
- 3) the right of using a land plot for agricultural purposes (emphyteusis);
- 4) the right to develop a land pot (superficies).

Similar comments are due with respect to Article 5, *Encumbrances Subject to Registration*.

Article 5 requires the state registration for encumbrances on the disposition and other powers of a real estate owner arising from the pledge (mortgage) of the property, judgment of a court of law or arbitration on securing a claim, judgment of an investigatory body on undertaking steps to support a civil suit or confiscation of the property, measures assuring the preservation of an inheritance, and on prohibition to alienate the property.

Clearly, these provisions need substantial revising.

For example, a rather acute issue of whether it is necessary to register the rights identified in Article 407 of the draft Civil Code, namely, the right of the members of the owner's family to use the premises. This Article states that members of the owner's family residing together with him shall have the right to use the premises in accordance with the law.

The premises they may occupy shall be determined by the owner.

Another important issue is raised in Article 12 of the draft law, *Reserve Fund of Bodies of State Registration of Rights*. It envisages the creation of a special reserve fund for compensating the damages of individual and corporate clients of the registration system by actions of the registration bodies.

The special reserve fund of the state registration bodies should be formed from the funds retained after the payment of all mandated fees and other payments.

The procedure for use and disposition of the monies in the special reserve fund of the bodies of state registration should be determined by the Cabinet of Ministers of the Ukraine.

At this point, it would be important to consider the guarantees of registered rights. Should the system of state registration of real estate rights guarantee the public reliability of entries in the State Register of Rights? What should be the mechanism of financial compensation for the losses of parties who relied on the register?

Article 19 of the draft, *Methodological and Regulatory Support for the Activities of Bodies for State Registration of Rights*, envisages that methodological and regulatory support for the activities of the registration bodies shall be provided by the State Committee for Construction, Architecture and Housing Policy of the Ukraine jointly with the Justice Ministry of the Ukraine.

First of all, it would be appropriate here to stress that rights to a land plot form the foundation, in the literal and oblique sense, for all real estate objects, while from the conceptual viewpoint the feasibility of a unified real estate cadastre should be noted.

Article 28 of the draft law⁴⁷, *Fee for the State Registration of Real Estate, the Rights Thereto, and Services Provided by Bodies of State Registration of Rights*, provides that the fees for the state registration of real estate, real estate rights and encumbrances, for the issuance of respective documents, the provision of data from the State Register of Rights, and for the services related to the state registration of real estate right shall be established by the bureaus for the state registration of rights.

A conflict of interests is clearly in place: the rights registration agencies, which represent the state, establish their fees at their own discretion, and may develop the desire to

⁴⁷ Law of the Ukraine, *On State Registration of Rights to Real Estate Objects*, as passed in the first reading.

increase them, contrary to the interests of their individual and corporate clients. Therefore, it is more reasonable to assign this task to the Government.

Of great importance is Section V of the law, *Concluding and Transitional Provisions*, particularly the provisions that says:

“Real estate objects and rights to them registered as of the time of coming into force of this law shall be deemed registered in the proper manner”.

The important point here is to carefully determine every aspect of the process of recognizing and registering the rights originated prior to this law. In Russia, for example, there are many problems around the rights originated prior to the registration law.

Our analysis has met with certain difficulties in formulating the position on the draft law *On Secured Transactions*,⁴⁸ which calls for the creation of a register of encumbrances of real properties, securities, and movable properties. However, the exhaustive explanations provided by Justin T. Holl,⁴⁹ alleviated these difficulties. A study of the draft Civil Code resulted in a clear understanding that from the legal viewpoint the Ukraine intends to create a normal system of real estate registration, including the registration of encumbrances.

4.4. Conclusions

The results of the analysis allow for the following conclusions.

The current legislative framework does not allow for active and reliable mortgage operations:

- the unavailability of a modern civil code deprives the system of a basis, while countries with the system of continental law traditionally regard a civil code as the main system-building law
- the Civil Code currently in effect, the laws On Pledge, On Executive proceedings, and On Bankruptcy, and several regulatory acts are not fully conciliated, which, given the current practices, may and actually does lead to situations when the mortgagee is unable to receive the money for one or even two years;
- the existing registration system is fragmented and does not fully guarantee clear titles or mortgagees' rights;
- neither the civil law nor the banking law creates adequate incentives for using the various modern financial instruments available (e.g., variable rate loans).

⁴⁸ Draft law *On Secured Transactions*.

⁴⁹ Movable and Immovable Registries: Distinct by Nature. Justin T. Holl Jr., Commercial Law Center, June 19, 2002.

It should be noted that the business community, public and state leaders have year to work out the approaches that need to be built into the law.

So far, there is no full understanding of the fact that mortgage lending involves the use of at least three different instruments: long-term loans for home purchases, commercial real estate mortgage loans, loans to agricultural farms for business activities collateralized by land plots. Residential construction lending is a special type of lending activity, with specific risks different from home purchase mortgages risks.

Neither is there adequate understanding of the fact that lending for housing construction is a special type of activity that is associated with specific risks.

A good illustration of the fact is that even the *Arkada Bank* - a strongly aggressive player on the quasi-mortgage market, treats retail lending for housing construction as mortgage lending and uses loans repayable in equal installments and interest accrual on the remaining balance of the principal debt rather than self-amortizing instruments.

This supports the feasibility of a debate on the general principles of mortgage lending implemented in the USA or Western Europe, through various seminars, conferences, roundtables, and an appropriate publication program.

The reviewed drafts of legislative acts require more work:

- the drafting process suffers, first of all, from lack of mutual coordination: the drafts of the new Civil Code, Mortgage Law and Registration Law do not fully correspond to one another;
- a highly refined draft of the new Civil code would benefit from certain improvements the articles related to the mortgage system, for example, in terms of the order of priority for satisfying the creditors' claims, and the registration of real estate rights;
- the good draft of the Mortgage Law fails to reflect the specific features of housing mortgage and land mortgage;
- the registration of real estate rights is facing both "conceptual" (what should be registered, how, and where) and "institutional" (the "chief" authority) differences;
- inadequate attention is paid to the need for revising the laws *On Executive Proceedings*, and *On Bankruptcy*, as well as many other documents which, taken together, are not less important than, for example, the mortgage law;
- the improvement of tax legislation for housing finance and mortgage lending proper is not clearly identified as a priority task.

5. Potential effective demand for mortgage loans

The creation of favorable legal and economic environment for housing mortgage lending will be justified only when there are ready purchasers of mortgage products on the market. In other words, only by estimating such factors as the housing and mortgage loan affordability and the potential effective demand it will be possible to conclude whether this market segment has or has no good prospects for upward trends and whether it is worthy to concentrate efforts on the development of mortgage lending mechanisms.

According to statistics provided by professional market participants, the approximate annual volume of housing transactions concluded on the Kiev housing market comes to 20-25 thousand deals, or 1-1.3 million sq. m, or USD 300-350 million.⁵⁰ So, it would be valid to suppose that at least 20 percent of these home purchasers would prefer to purchase housing by raising a mortgage loan rather than just spending their own savings (as some of them really did). If we presume that average LTV of these loans is 50 percent, the total size of loans extended will then approximate to USD 30-35 million, and their number – to 2-2,5 thousand deals.

Two thousand mortgage loans with total amount of USD 30 million is a rather great sum even for Kiev. So, we should assess to what extent we may rely on these estimates. To this end, it is better to use more exact than presumed statistics as source data and more accurate methods of estimation of the housing mortgage capacity. So, we decided to use the available official statistics (household expenses, qualitative and quantitative parameters of housing property) and statistics provided by real estate brokers on average prices of housing of various sizes.

Urban households are selected to serve as a target group for the purposes of this analysis (i. e. the population group that presumably can use a mortgage loan for home purchase). There are two reasons for this selection: first, at present rural household incomes are much lower than urban ones, and they substantially lower down the national household income averages which, if used as source data, will produce a very pessimistic outlook, moreover that the methods of analysis we apply are also rather conservative. Second, there is no regular statistics on rural real property prices, which also makes impossible the accurate estimation of the capacity and mortgage demand of the rural housing market.

Thus, our further estimations will be based on data provided by the Ukrainian State Statistics Committee and showing the level of urban household expenses. According to this statistics, in 2001 the average urban household (the statistic size of which is 2.68 persons) spent UAH 540.34, or USD 100.62.⁵¹ As is evident, the urban household income was also very low to meet the bank's mortgage lending standards. However, the

⁵⁰ Source: the Ukrainian Association of Real Estate Brokers (Realtors)

⁵¹ Source: Statistical bulletin, *Household Incomes and Expenses in 2001 (based on findings of the Ukrainian household sample survey)*. Goscomstat of Ukraine, 200



affordability of housing mortgage loans is not similar for all households, because it directly depends on their income status and, thus, will be different for different household income groups. Therefore, it is necessary to arrange the expenditure statistics by household groups of the similar size ranging them from the lowest to highest expenditure level.

The available statistics on the household income structure makes it possible to determine the national expenditure percentage for every decile group. The table below is designed to show this statistics.

Table 17

Urban Household Expenditure Structure by Decile Groups, Ukraine, 2001

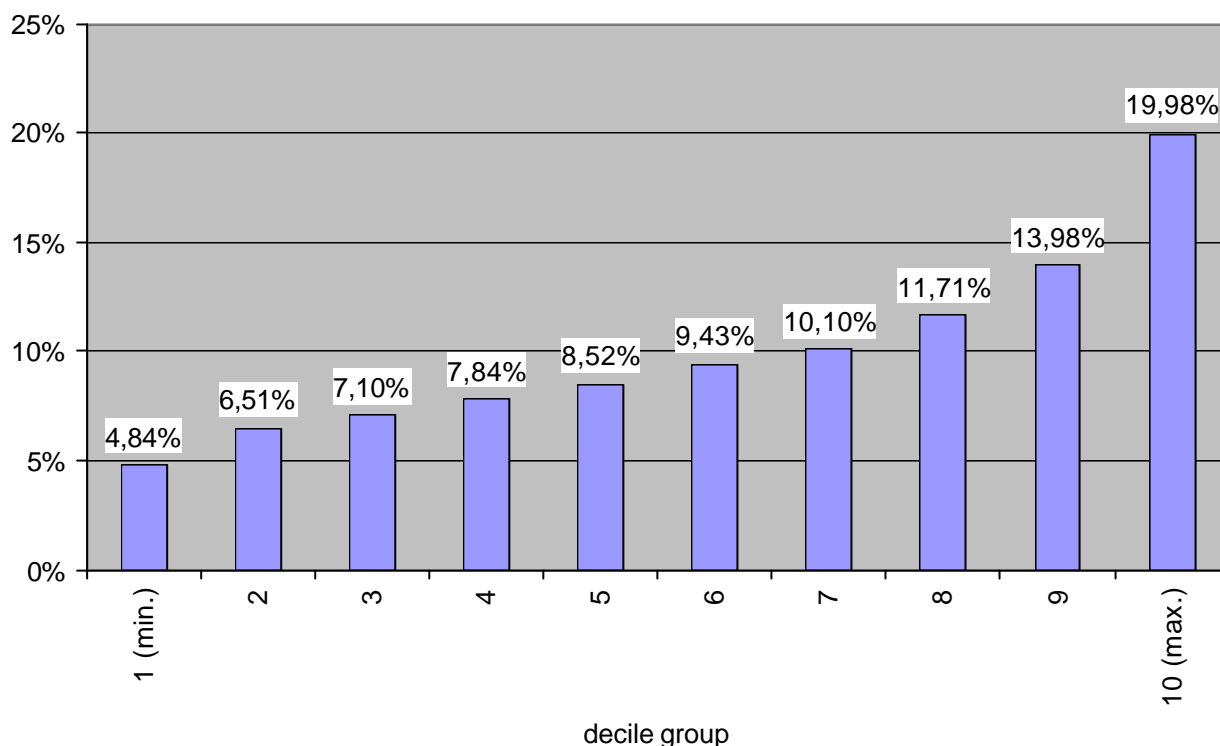
Income group	Average monthly expenses per household		
	UAH	USD	%
1 (min.)	261,77	48,75	4,84%
2	351,54	65,46	6,51%
3	383,49	71,41	7,10%
4	423,91	78,94	7,84%
5	460,29	85,72	8,52%
6	509,37	94,85	9,43%
7	545,89	101,66	10,10%
8	632,64	117,81	11,71%
9	755,39	140,67	13,98%
10 (max.)	1 079,63	201,05	19,98%
average	540,39	100,63	

Source: *Statistical bulletin, Household Incomes and Expenses in 2001 (based on findings of the Ukrainian household survey). Goscomstat of Ukraine, 2002*



Figure 18

Urban Household Expenditure Structure by Decile Groups, Ukraine, 2001



Source: Statistical bulletin, Household Incomes and Expenses in 2001 (based on findings of the Ukrainian household survey). Goscomstat of Ukraine, 2002

Using the averages showing household incomes, housing prices and size of standard units and suppositions stated below we will estimate the affordability of housing mortgage loans for specific urban client groups in Ukraine and the potential demand for them.

In order to produce an outlook of the mortgage lending development in Ukraine, at least at its initial stage, we will focus our analysis on households – homeowners that would like to improve their living conditions by selling the housing they already own and purchasing a new one of better quality. Additionally, we will study the case of purchase of low-price housing (one-room apartments) by households that either have no housing at all or have but do not want to sell it.

In October 2002, housing prices in Ukrainian cities averaged at USD5,300 for a standard one-room apartment of good quality, USD8,400 – for a two-room apartment,

USD14,800 – for a three-room apartment.⁵² These values are also used for estimating the share of household income that it can afford to spend on new housing.

Other sources of revenues in addition to that received from the sale of available housing are banking deposits, savings, jewelry, a garage, a car etc. As it is rather difficult to determine the pledge value of these resources we presume that total household savings may be equal either to three-month or six-month total expenses of a household. Subsequently, the loan affordability and demand rate are estimated for each of these options.

The current practices of retail lending and most likely trends in this area in the nearest future make it possible to presume that housing mortgage loans are provided at 16 percent per annum (for most popular USD-denominated loans), for 5 year repayment period with principal and interest paid by equal monthly installments. In other works that these mortgage loans are self-amortizing, with the fixed interest rate and annuity debt service payments.

By using data on household savings and the loan interest rate and repayment terms it is possible to determine the size of a loan that a household can afford to raise subject to the standard limiting condition that the monthly debt service payment (principal plus interest) should not exceed 35 percent of the household aggregate monthly income. This standard is commonly used by the majority of countries with a mature mortgage market as well as by most Ukrainian banks for evaluation of the paying capacity of their clients.

Thus, the formula for determining the affordable loan size is:

$$L = PMT \left[\frac{1 - \frac{1}{(1+i)^n}}{i} \right]$$

where

L is a loan size;

i is an interest rate;

n is a number of payment periods (total number of months in the repayment period);

PMT is the size of a monthly debt service payment (principal plus interest).

The PMT value is determined as follows:

⁵² The cited indicators are averaged. Source: statistics provided by the Ukrainian Association of Real Estate Brokers.

$$PMT = ME \times 0.3$$

where

ME is total monthly expenses of a household.

The determined maximum affordable size of a loan makes it possible to determine the paying capacity of the household, A_j , which can manifest itself in the form of the secondary housing market demand:

$$PA_j = RE + S + L$$

where

j is the income group to which a household is referred to;

PA_j is the paying capacity of a household of A_j type;

S is an amount of additional savings;

L is a loan size.

As we have mentioned above, our estimations of the housing and mortgage loan demand are based on the secondary market indicators and statistics on households that agree to sell their available housing and raise a loan in order to purchase a new one. These households may be classified into three groups: households that have a one-room apartment and want to buy a two-room apartment; households that have a two-room apartment and want to buy a three-room one; and households that want to buy new housing without selling the one they already own.

For better illustration of the paying capacity of different income groups of households we suggest to convert this indicator from money to natural terms, i. e. show it in terms of square meters of housing that a household of A_j type can afford to buy. To this end, the money-denominated paying capacity is divided by the average cost of 1 sq. m of standard housing and related to the average size of a standard unit that a household would like to buy to see whether the household's wish is feasible. Henceforward, all our further estimates will be made only for households that can afford raising a mortgage loan to improve their living conditions.

Having estimated the total effective demand for housing for each of the three types of households (owners of one-room apartments, owners of two-room apartment and homeowners that would like to buy a new home without selling the one they already have) we can determine how many units of greater size these households can buy. The obtained indicator will just show the total effective demand for one-room, two-room and three-room apartments. However, this demand does not imply only housing purchase transactions. By exploring the situation on the Ukrainian housing market and comparing it with foreign countries' experience we made a suggestion that the household mobility rate in the nearest future would average at just 5 percent of households per year, which implies that only 5 percent of households that can afford buying a new unit will in fact try to do that. Additionally, by taking into consideration traditional preferences of Ukrainian



households we suggested that nearly a half of prospective buyers had some other additional resources and/or social benefits due to which they could purchase or construct a new housing without a mortgage debt. So, it is important to multiply the earlier estimated total demand indicators by these two factors: 0.05 and 0.50.

The tables below show the final results of our estimations.

Table 19

**Affordability of one-room apartments by means of mortgage loan without selling of existing housing property
(variant 1: savings = three-months income)**

Income group	Income (USD per month)	Equity per HH (USD)	Savings per HH (USD)	Maximum possible loan amount per HH (USD)	Number of households in the group	Unit purchase affordability (USD)		Potential number of square meters affordable for purchasing (sq.m)		Average total area of one-room bigger apartment (sq.m)	Available / Not available
						per HH	per group	per HH	per group		
1	2	3	4	5	6	7	8	9	10	11	12
1	48,75	0	146	702	203 932	848	172 911 722	5	1 052 106	32	NA
2	65,46	0	196	942	203 932	1 139	232 180 540	7	1 412 736	32	NA
3	71,41	0	214	1 028	203 932	1 242	253 284 638	8	1 541 147	32	NA
4	78,94	0	237	1 136	203 932	1 373	279 992 849	8	1 703 657	32	NA
5	85,72	0	257	1 234	203 932	1 491	304 040 879	9	1 849 980	32	NA
6	94,85	0	285	1 365	203 932	1 650	336 424 141	10	2 047 021	32	NA
7	101,66	0	305	1 463	203 932	1 768	360 578 578	11	2 193 992	32	NA
8	117,81	0	353	1 696	203 932	2 049	417 861 128	12	2 542 536	32	NA
9	140,67	0	422	2 025	203 932	2 447	498 943 425	15	3 035 893	32	NA
10	201,05	0	603	2 894	203 932	3 497	713 105 678	21	4 338 994	32	NA
Average	101.96	0	302	1 448	203 932	1 750		11		32	NA
Total					2 039 320		3 569 323 579		21 718 063		

Total number of two-room apartments affordable for purchasing by owners of one-room units: 0
 Effective demand on residential mortgage loans (number of loans) 0
 Effective demand on residential mortgage loans total volume of loans) 0 USD

Sources: *Statistical bulletin, Household Incomes and Expenses in 2001 (based on findings of the Ukrainian household survey). Goscomstat of Ukraine, 2002;*
Statistical bulletin «Housing Stock of Ukraine in 2001», Goscomstat of Ukraine, 2002;
data from the Association of Real Estate Specialists (Realtors) of Ukraine.



Table 20

**Affordability of two-room apartments for the owners of one-room apartments by means of mortgage loan
(variant 1: savings = three-months income)**

Income group	Income (USD per month)	Equity per HH (USD)	Savings per HH (USD)	Maximum possible loan amount per HH (USD)	Number of households in the group	Unit purchase affordability (USD)		Potential number of square meters affordable for purchasing (sq.m)		Average total area of one-room bigger apartment (sq.m)	Available / Not available
						per HH	per group	per HH	per group		
1	2	3	4	5	6	7	8	9	10	11	12
1	48,75	5 300	146	702	203 932	6 148	1 253 751 322	34	6 914 882	46	NA
2	65,46	5 300	196	942	203 932	6 439	1 313 020 140	36	7 241 770	46	NA
3	71,41	5 300	214	1 028	203 932	6 542	1 334 124 238	36	7 358 167	46	NA
4	78,94	5 300	237	1 136	203 932	6 673	1 360 832 449	37	7 505 472	46	NA
5	85,72	5 300	257	1 234	203 932	6 791	1 384 880 479	37	7 638 105	46	NA
6	94,85	5 300	285	1 365	203 932	6 950	1 417 263 741	38	7 816 710	46	NA
7	101,66	5 300	305	1 463	203 932	7 068	1 441 418 178	39	7 949 931	46	NA
8	117,81	5 300	353	1 696	203 932	7 349	1 498 700 728	41	8 265 864	46	NA
9	140,67	5 300	422	2 025	203 932	7 747	1 579 783 025	43	8 713 062	46	NA
10	201,05	5 300	603	2 894	203 932	8 797	1 793 945 278	49	9 894 242	46	A
Average	101.96	5 300	302	1 448	203 932	7 050		39		46	NA
Total					2 039 320		14 377 719 579		79 298 204		

Total number of two-room apartments affordable for purchasing by owners of one-room units: 213 565
 Effective demand on residential mortgage loans (number of loans) 5 339
 Effective demand on residential mortgage loans total volume of loans) 14 752 602 USD

Sources: Statistical bulletin, Household Incomes and Expenses in 2001 (based on findings of the Ukrainian household survey). Goscomstat of Ukraine, 2002;
 Statistical bulletin «Housing Stock of Ukraine in 2001», Goscomstat of Ukraine, 2002;
 data from the Association of Real Estate Specialists (Realtors) of Ukraine.



Table 21

**Affordability of three-room apartments for the owners of two-room apartments by means of mortgage loan
(variant 1: savings = three-months income)**

Income group	Income (USD per month)	Equity per HH (USD)	Savings per HH (USD)	Maximum possible loan amount per HH (USD)	Number of households in the group	Unit purchase affordability (USD)		Potential number of square meters affordable for purchasing (sq.m)		Average total area of one-room bigger apartment (sq.m)	Available / Not available
						per HH	per group	per HH	per group		
1	2	3	4	5	6	7	8	9	10	11	12
1	48,75	8 400	146	702	331 483	9 248	3 065 514 327	38	12 607 632	61	NA
2	65,46	8 400	196	942	331 483	9 539	3 161 853 214	39	13 003 848	61	NA
3	71,41	8 400	214	1 028	331 483	9 642	3 196 157 007	40	13 144 930	61	NA
4	78,94	8 400	237	1 136	331 483	9 773	3 239 570 042	40	13 323 476	61	NA
5	85,72	8 400	257	1 234	331 483	9 891	3 278 659 070	41	13 484 239	61	NA
6	94,85	8 400	285	1 365	331 483	10 050	3 331 296 655	41	13 700 723	61	NA
7	101,66	8 400	305	1 463	331 483	10 168	3 370 558 643	42	13 862 197	61	NA
8	117,81	8 400	353	1 696	331 483	10 449	3 463 668 938	43	14 245 135	61	NA
9	140,67	8 400	422	2 025	331 483	10 847	3 595 464 686	45	14 787 175	61	NA
10	201,05	8 400	603	2 894	331 483	11 897	3 943 576 117	49	16 218 863	61	NA
Average	101.96	8 400	302	1 448	331 483	10 150		42		61	NA
Total					2 039 320		33 646 318 700		138 378 220		

Total number of two-room apartments affordable for purchasing by owners of one-room units: 0
 Effective demand on residential mortgage loans (number of loans) 0
 Effective demand on residential mortgage loans total volume of loans) 0 USD

Sources: Statistical bulletin, Household Incomes and Expenses in 2001 (based on findings of the Ukrainian household survey). Goscomstat of Ukraine, 2002;

Statistical bulletin «Housing Stock of Ukraine in 2001», Goscomstat of Ukraine, 2002;

data from the Association of Real Estate Specialists (Realtors) of Ukraine.



Table 22

**Affordability of one-room apartments by means of mortgage loan without selling of existing housing property
(variant 2: savings = six-months income)**

Income group	Income (USD per month)	Equity per HH (USD)	Savings per HH (USD)	Maximum possible loan amount per HH (USD)	Number of households in the group	Unit purchase affordability (USD)		Potential number of square meters affordable for purchasing (sq.m)		Average total area of one-room bigger apartment (sq.m)	Available / Not available
						per HH	per group	per HH	per group		
1	2	3	4	5	6	7	8	9	10	11	12
1	48,75	0	293	702	203 932	994	202 736 777	6	1 233 581	32	NA
2	65,46	0	393	942	203 932	1 335	272 228 707	8	1 656 415	32	NA
3	71,41	0	428	1 028	203 932	1 456	296 972 990	9	1 806 975	32	NA
4	78,94	0	474	1 136	203 932	1 610	328 288 025	10	1 997 516	32	NA
5	85,72	0	514	1 234	203 932	1 748	356 484 032	11	2 169 078	32	NA
6	94,85	0	569	1 365	203 932	1 934	394 452 991	12	2 400 106	32	NA
7	101,66	0	610	1 463	203 932	2 073	422 773 760	13	2 572 428	32	NA
8	117,81	0	707	1 696	203 932	2 402	489 936 815	15	2 981 091	32	NA
9	140,67	0	844	2 025	203 932	2 869	585 004 769	17	3 559 546	32	NA
10	201,05	0	1 206	2 894	203 932	4 100	836 107 263	25	5 087 415	32	NA
Average	101.96	0	604	1 448	203 932	2 052		12		32	NA
Total					2 039 320		4 184 986 130		25 464 150		

Total number of two-room apartments affordable for purchasing by owners of one-room units: 0
 Effective demand on residential mortgage loans (number of loans) 0
 Effective demand on residential mortgage loans total volume of loans) 0 USD

Sources: Statistical bulletin, Household Incomes and Expenses in 2001 (based on findings of the Ukrainian household survey). Goscomstat of Ukraine, 2002;

Statistical bulletin «Housing Stock of Ukraine in 2001», Goscomstat of Ukraine, 2002;

data from the Association of Real Estate Specialists (Realtors) of Ukraine.



Table 23

**Affordability of two-room apartments for the owners of one-room apartments by means of mortgage loan
(variant 2: savings = six-months income)**

Income group	Income (USD per month)	Equity per HH (USD)	Savings per HH (USD)	Maximum possible loan amount per HH (USD)	Number of households in the group	Unit purchase affordability (USD)		Potential number of square meters affordable for purchasing (sq.m)		Average total area of one-room bigger apartment (sq.m)	Available / Not available
						per HH	per group	per HH	per group		
1	2	3	4	5	6	7	8	9	10	11	12
1	48,75	5 300	293	702	203 932	6 294	1 283 576 377	35	7 079 377	46	NA
2	65,46	5 300	393	942	203 932	6 635	1 353 068 307	37	7 462 650	46	NA
3	71,41	5 300	428	1 028	203 932	6 756	1 377 812 590	37	7 599 123	46	NA
4	78,94	5 300	474	1 136	203 932	6 910	1 409 127 625	38	7 771 837	46	NA
5	85,72	5 300	514	1 234	203 932	7 048	1 437 323 632	39	7 927 348	46	NA
6	94,85	5 300	569	1 365	203 932	7 234	1 475 292 591	40	8 136 760	46	NA
7	101,66	5 300	610	1 463	203 932	7 373	1 503 613 360	41	8 292 959	46	NA
8	117,81	5 300	707	1 696	203 932	7 702	1 570 776 415	42	8 663 387	46	NA
9	140,67	5 300	844	2 025	203 932	8 169	1 665 844 369	45	9 187 720	46	NA
10	201,05	5 300	1 206	2 894	203 932	9 400	1 916 946 863	52	10 572 639	46	A
Average	101.96	5 300	604	1 448	203 932	7 352		41		46	NA
Total					2 039 320		14 993 382 130		82 693 800		

Total number of two-room apartments affordable for purchasing by owners of one-room units: 228 208
 Effective demand on residential mortgage loans (number of loans) 5 705
 Effective demand on residential mortgage loans total volume of loans) 14 752 602 USD

Sources: Statistical bulletin, Household Incomes and Expenses in 2001 (based on findings of the Ukrainian household survey). Goscomstat of Ukraine, 2002;

Statistical bulletin «Housing Stock of Ukraine in 2001», Goscomstat of Ukraine, 2002;

data from the Association of Real Estate Specialists (Realtors) of Ukraine.



Table 24

**Affordability of three-room apartments for the owners of two-room apartments by means of mortgage loan
(variant 2: savings = six-months income)**

Income group	Income (USD per month)	Equity per HH (USD)	Savings per HH (USD)	Maximum possible loan amount per HH (USD)	Number of households in the group	Unit purchase affordability (USD)		Potential number of square meters affordable for purchasing (sq.m)		Average total area of one-room bigger apartment (sq.m)	Available / Not available
						per HH	per group	per HH	per group		
1	2	3	4	5	6	7	8	9	10	11	12
1	48,75	8 400	293	702	331 483	9 394	3 113 993 658	39	12 807 015	61	NA
2	65,46	8 400	393	942	331 483	9 735	3 226 949 767	40	13 271 573	61	NA
3	71,41	8 400	428	1 028	331 483	9 856	3 267 170 525	41	13 436 990	61	NA
4	78,94	8 400	474	1 136	331 483	10 010	3 318 071 752	41	13 646 333	61	NA
5	85,72	8 400	514	1 234	331 483	10 148	3 363 903 136	42	13 834 825	61	NA
6	94,85	8 400	569	1 365	331 483	10 334	3 425 620 029	43	14 088 650	61	NA
7	101,66	8 400	610	1 463	331 483	10 473	3 471 654 206	43	14 277 976	61	NA
8	117,81	8 400	707	1 696	331 483	10 802	3 580 824 833	44	14 726 965	61	NA
9	140,67	8 400	844	2 025	331 483	11 269	3 735 353 658	46	15 362 501	61	NA
10	201,05	8 400	1 206	2 894	331 483	12 500	4 143 509 847	51	17 041 137	61	NA
Average	101.96	8 400	604	1 448	331 483	10 452		43		61	NA
Total					2 039 320		34 647 051 410		142 493 963		

Total number of two-room apartments affordable for purchasing by owners of one-room units: 0
 Effective demand on residential mortgage loans (number of loans) 0
 Effective demand on residential mortgage loans total volume of loans) 0 USD

Sources: *Statistical bulletin, Household Incomes and Expenses in 2001 (based on findings of the Ukrainian household survey). Goscomstat of Ukraine, 2002;*

Statistical bulletin «Housing Stock of Ukraine in 2001», Goscomstat of Ukraine, 2002;

data from the Association of Real Estate Specialists (Realtors) of Ukraine.

Thus, estimations based on the Ukrainian Goscomstat and ASNU data⁵³ demonstrate that today only one from the ten defined income groups can afford purchasing of a larger housing unit by taking a standard mortgage loan. This group is owners of one-room apartments willing to improve their living conditions by raising a mortgage loan. Outcomes of our estimations are summarized in the table below.

⁵³ The Ukrainian State Committee of Statistics (Goscomstat), and the Ukrainian Association of Real Estate Brokers (ASNU).

Table 25

Evaluation of the Ukrainian housing mortgage market capacity

Transaction type	Eligible monthly household average income (from those presented)	Standard savings rate	Market capacity		
			Number of loans	Total amount of loans, USD	Average size of a loan, D
Mortgage loans for households purchasing 1-room apartments without sale of existing housing	-	3-months expenses	-	-	-
		6-months expenses	-	-	-
Mortgage loans for households purchasing 2-room apartments (and selling existing 1-room apartments)	More UAH 1,080 (more USD 201)	3-months expenses	5,339	14,752,602	2,763
		6-months expenses	5,705	14,752,602	2,586
Mortgage loans for households purchasing 3-room apartments (and selling existing 2-room apartments)	-	3-months expenses	-	-	-
		6-months expenses	-	-	-

Sources: *Statistical bulletin, Household Incomes and Expenses in 2001 (based on findings of the Ukrainian household survey). Goscomstat of Ukraine, 2002;*

Statistical bulletin «Housing Stock of Ukraine in 2001», Goscomstat of Ukraine, 2002;

data from the Association of Real Estate Specialists (Realtors) of Ukraine.

As is evident from the table, in the current 2002, mortgage loans may be raised by 5,300-5,700 Ukrainian urban households ready to sell their existing housing in order to buy a new better one. The amount of such credits totals to USD 15 million.

The above stated estimations need some commentary. First, it is worthy to note that some assumptions used as the basis for making our outlook may vary from actual indicators. For example, the presumed 16 percent interest rate may be, in fact, lower or higher. The same variations may be in the repayment period. If, presumably, interest rates grow and the repayment period is reduced, mortgage loans will become less affordable for prospective borrowers, and the demand for them will go down.

Second, there is also a great likelihood that these indicators will demonstrate quite an opposite trend thus improving the loan affordability and demand. Moreover, it is worth to



bear in mind that our outlook covers only households living in small standard apartments, while there is also a rather large group of well-to-do households that have larger incomes and live in by far better and larger apartments (and may also sell their existing property in order to remove to more luxurious apartments or country houses). Third, the available income and expenditure statistics is quite evidently understated because typically it is based on data provided by questionnaire surveys and employers.

Finally, it is also very important to have a good understanding of specific methods we used to evaluate the capacity of the housing mortgage market. This specificity is, first and foremost, driven by the goal to show that there is an effective, although yet limited, demand for mortgage loans in most Ukrainian cities. This conclusion, in turn, points at the necessity to take steps for the creation of favorable legal, economic and political environment for both creditors and borrowers, which will immediately advance the development of the housing mortgage market not only in Kiev, but in all other large Ukrainian regions.

All said above indicates that our outlook may be treated as rather reasonable for the next 1-2 years.

The reported outcomes of the research prove that Ukraine does have an effective demand for housing mortgage loans although it is still very limited in size. Nonetheless, first, it is suffice to start the practical testing and development of mortgage lending mechanisms by various governmental and commercial institutions interested in the further development of the national real estate market, and second, the low affordability of mortgage loans is a result of low household incomes and too short repayment periods, which may be corrected by a program of measures targeted to induce the growth in this sector of economy.

6. The prospects of development of the mortgage lending system in Ukraine

6.1. Limiting and favorable factors of the further development of the mortgage lending

The current situation in the housing financing sector can be characterized by a number of negative factors, hindering the development of the housing mortgage lending in the Ukraine, but certain favorable factors are present as well, which are capable of encouraging further development of the sector in the future. In particular, the following factors can be viewed as limiting the development of the housing financing market in the present:

- Imperfection of the current legislation, establishing the conditions of performing mortgage lending activity, in particular, the existing foreclosure problems, lack of regulation of the activities of the trusteeship agencies in connection with real estate transactions, etc.
- Absence of the land market: de jure in the rural areas and de facto in the cities;
- Low effective demand;
- Lack of long-term resources available to the banks as a finance basis for long-term mortgage lending; small volumes of deposited funds; unaffordability of long-term and relatively cheap resources of the domestic and foreign investors for most of the banks;
- High price of financial resources on the domestic financial market, determining the high interest rates on loans and making them unaffordable for the majority of prospective borrowers;
- Lack of professional operation standards for the various participants of the real estate market and banking sector;
- Lack of the system of life and disability insurance of the borrower;
- Small number of banking specialists trained to work with mortgage loans;
- Absence of domestic and foreign institutional investors;
- Lack of the comprehensive program of development of the mortgage lending market in the Ukraine

Housing mortgage lending segment is present in the Ukraine, but on a rather small scale. The majority of funds, directed to the financing of the purchase of housing, go to large construction holdings, which are interested in promoting the demand for the housing that they construct. These are mainly large Kiev-based companies, Kievgorstroy Construction Company and Arkada Bank being the largest without a doubt. Some full-service commercial banks are also involved in the housing financing to a varying degree, but the share of housing loans in their credit portfolios does not

exceed 1 – 3%. In addition, housing financing of the citizens is also performed by the state by way of implementing a number of subsidized social assistance programs, however the present and the future volumes of these programs are limited by the insufficiency of the budget resources.

Analysis of the situation demonstrates that the volume of mortgage lending cannot be increased without serious quality changes in the existing practice of financing of housing purchase and construction, as well as in the legal regulation of this activity. Forming the national system of mortgage lending is possible only on the basis of unified standards of activity of all the present and future participants. Also, the market is still lacking certain important institutional elements, necessary for the creation of a well-developed mortgage lending system, e.g. the insurance against the mortgage lending risks, institutional investors, etc.

At the same time, certain favorable factors have to be noted which prove the possibility of further development of the housing mortgage lending market in the Ukraine. The most important favorable factors are:

- The existing real estate market, with prices having a stable upward tendency;
- Existence of banks who have mortgage lending experience and are interested, in principle, in expanding this segment of their activity;
- The need for speedy development of the mortgage lending, expressed by professional participants of the credit and real estate markets, as well as by the population;
- Increased (declared) interest of the state in promoting the development of the housing mortgage lending and consequently – in promoting the development of the real estate market, employment of the population, etc.

Among the favorable factors of the development of the long-term mortgage lending is also the existence of a stable demand for residential and commercial real estate in Kiev and a number of other economic centers of the Ukraine. This enables the construction companies and the banks to increase their interest in participation in the financing of housing construction and purchase.

Another important factor is a relative decrease in the profitability of alternative ways of capital expenditure, which promotes the extension of real estate transactions by all the market participants.

Another favorable factor is the increase of funds on bank deposits, as well as improved liquidity situation.

Many agencies, state as well as private, express their interest in the development of mortgage lending. On the one hand, this can have a very positive impact on the overall macroeconomic stability, on the other hand, this will enable many banks and companies of the construction sector to gain long-term prospects of stable activity. In the long run, the creation of the primary mortgage lending market will facilitate the solution of the problems of forming reliable capital expenditure instruments for the systematic domestic investors, such as pension funds.

An unquestionable favorable factor is the establishment of the National Mortgage Lending Association of the Ukraine, aimed at the participation in development and promotion of many specific solutions necessary for the creation of the system of incentives and regulators of the mortgage lending in the Ukraine. There are certain signs showing that the Association can claim the role of the chief organizer for this type of activities.

Finally, another factor indicating the possibility of development of the housing mortgage lending in the Ukraine is the real demand for residential real estate, as well as for the mortgage loans themselves. There is an ongoing process of the formation of the middle class, with income of USD 400 – 800 per month (at least, this can be observed in Kiev, and to a lesser extent – in several large regional centers). This middle class is the main prospective consumer of the mortgage loans. Optimistic and pessimistic estimates of the market capacity of such loans fluctuate between USD 15 and 30 mln. for 2002-2003, and there are stable possibilities for further growth on the condition of stable economic and political development.

All this signifies the existence of the real possibilities for growth of the mortgage lending market in the Ukraine.

6.2. Measures necessary for promoting the primary and secondary real estate financing markets

6.2.1. Goals and objectives

The objective of the measures on promoting housing mortgage lending in the Ukraine is the forming of modern financing mechanism for provision of housing to the population with the use of the citizens' own funds and credit resources of the banks in the form of long-term housing mortgage loans.

The successful implementation of this program will result in creation of real financial possibilities for the majority of the population to improve their housing conditions and increased affordability of the mortgage loans for a wider range of population. This, in turn, will produce the following results:

- Ensuring the affordability of housing for the majority of population;
- Increased effective demand for housing;
- Attracting of investors' funds into the mortgage lending sector on the basis of creating the secondary mortgage loan market and the market of securities covered by mortgage;
- Creating the mechanism of attracting non-budget funds into the housing sector.

The following goals have to be achieved in order to create a well-balanced system of mortgage lending:

1. Improvement of the legislative and regulatory framework of the banks' mortgage lending activities, with a view to minimize the existing risks.
2. Formation of unified primary mortgage loan market by way of developing and introducing into the banking practice the standards and procedures of mortgage lending.
3. Creation of the institutional infrastructure of the mortgage lending market: development of the insurance system, insurance of borrowers and property rights; formation of an adequate system of registration of rights to real estate and real estate transactions, accessibility of the pertinent information for the participants of the mortgage lending market; organization of the information system containing systematized data on the real estate market.
4. Introduction of state incentives for certain participants of the mortgage lending market: tax incentives for the citizens receiving mortgage loans, as well as for the banks issuing them.
5. Formation of regulatory and legal basis for the use of new types of securities secured by mortgage loans, in order to create conditions for attracting long-term resources into the mortgage lending sector.
6. Formation of the basis for the secondary mortgage loan market in order to attract long-term resources into the mortgage lending sector; creation of refinancing options for the long-term mortgage loans issued by the banks.
7. Creation of the rating system for the banks involved in mortgage lending activity and securities covered by mortgage loans, for the purpose of increasing their reliability and attractiveness for the prospective investors.
8. Development and introduction of the training program on the basics and procedures of mortgage lending for the banking specialists and other participants of the mortgage loan market.

6.2.2. Strategy and sequence of measures

Development of the mortgage lending system in the Ukraine can be presented as an iterative and multistage process, which includes the complex of various measures on forming the primary and secondary mortgage loan markets.

Creation of the housing mortgage lending system can be divided into several principal stages, although we have to keep in mind that this division is conceptual and does not imply that the measures of a certain stage have to be performed in any exact order. The majority of measures on creation of the environment for the development of the mortgage lending have to be worked on simultaneously, varying only in the degree and possibility of their practical implementation. This is determined by the creation of appropriate financial, economic, regulatory and legal conditions for the implementation of program measures.

There are the following principal stages of the developing of the mortgage lending system:

First stage – creating conditions for the development of the primary mortgage loan market, development of the mortgage lending standards and procedures minimizing the risks.

This stage includes complex methodological, consultative and training activities aimed at preparing the banks to work with mortgage loans. The methods of evaluating the mortgage loans feasibility and security are developed; also the procedures for issuing and servicing mortgage loans are developed and adapted to specific situations, as well as the methods of mortgage lending risk management and the ways of lowering them.

Creation of the legislative and regulatory basis corresponding to the specific characteristics of the mortgage lending.

The main goal of this stage is creating the environment that would allow to make the mortgage lending activity more attractive for the banks and turn the mortgage lending market into the real sector of economy.

At the same time, the work should be conducted on the development of the mortgage loan market infrastructure: insurance, real estate, appraisal companies, the system of registration of the rights to real estate, etc. For the purpose of preparing for the creation of the secondary mortgage loan market, it is also advisable to create a mechanism of certification and reliability evaluation of the mortgage lending products, offered by the banks. This task can be performed by independent consulting companies or rating agencies.

Second stage – extension of the securities issue practice of the banks, which perform mortgage lending transactions. The following three options for issuing securities should be examined and evaluated (one of the options is represented in the practice of the Arkada Bank):

1. The bank issues bonds secured by its mortgage loans. As the bank assets are not standardized, and have different yield, reliability and risk level, the mortgage loan assets should be presented as a separate item. These assets can serve as coverage for the bonds issued by the banks, the terms and yield of which will correspond to the structure of the mortgage loan portfolio.

In order to implement this option, it is necessary to work on theoretical and methodological issues, as well as legislative aspects of the issue of securities covered by mortgage loans.

2. Specialized licensed mortgage banks are created the activities of which are specially regulated by the law. Mortgage lending activities will constitute the majority of operations of such banks. The law should regulate all parameters of the mortgage loans issued by these banks, as well as the types and structure of active operations permissible for the mortgage banks. Such strict regulatory

actions determine the reliability and high liquidity of the securities issued by the mortgage banks and covered by mortgage loans.

This option requires serious legislative work, including the adoption of law on mortgage banks, introduction of amendments into the current laws regulating the securities market, as well as into regulatory documents regarding the banking activity (in order to adopt certain tax benefits for mortgage banks, change the reserve standards, etc.).

3. Regular full-service banks issue securities (bonds) covered by all their assets. The reliability and high rating of the bank can ensure the high liquidity of such bonds. The funds received from the sale of these bonds are used for mortgage lending. This option is the least interesting for the mortgage lending development, as there are no direct ties between the securities and mortgage assets, which can not provide additional reliability to them.

In order to develop the market of securities covered by mortgage loans, it is necessary to create a system ensuring the reliability of these financial instruments. Only high reliability will attract the investors, including pension funds. In addition to this, the pension funds are obliged to obtain permission for investing a portion of their funds into the mortgage securities. This decision can only be made on condition of guaranteed reliability and profitability of the securities covered by the mortgage loans.

The following measures should facilitate the reliability of the mortgage securities:

- Development of the rating system for the banks, including those involved in mortgage lending activity;
- The banks planning to issue securities should be required to undergo international audit procedure;
- Rating of the securities as a compulsory condition for their issue;
- Involvement of foreign investment banks for structuring the securities issued by the banks.

However, the securities issued by the banks, in a certain sense, will not be of uniform nature: they will be backed by different crediting products, which the investors will not always be able to evaluate.

Therefore, in the course of the primary mortgage market development and increase of the mortgage lending finance base, it is necessary to form the conditions for the creation of the unified market of securities covered by mortgage loans. A specialized secondary mortgage market organization could become a key element of this market.

Third stage – forming the unified, standardized and highly liquid market of securities covered by mortgage loans by way of creating a specialized institution of the secondary mortgage loan market. In particular, such companies as Fanny May (USA), Kazakh Mortgage Company (Kazakhstan) and Housing Mortgage Lending Agency (Russia) can serve as possible examples of similar institutions.

The Mortgage Agency is created with participation of the state and under its direct control. The main functions of the company will be as follows:

- Development and introduction of unified procedures and standards for issuing and servicing mortgage loans, ensuring the minimization of mortgage lending risks and increase in the reliability of the securities issued by the Mortgage Agency;
- Ensuring the attraction of long-term resources into the mortgage lending sector by selling the mortgage covered securities to the investors and organizing the refinancing of the mortgage loans issued by banks.

The reliability of the securities issued by the Mortgage Agency is ensured by a number of factors:

- The availability of the guarantee system, consisting of state guarantees at the expense of the state budget funds or guarantees of the regional authorities;
- providing coverage for the securities in the form of standardized mortgage loans with high level of reliability and guaranteed repayment by borrowers;
- selection of the partner banks by the Mortgage Agency in accordance with the established requirements;
- bank's obligation to repurchase problem loans, the rights under which were assigned to the Mortgage Agency;
- housing mortgage as security for the loans;
- compulsory personal insurance of the borrower (life and disability insurance), as well as insurance of the value of the mortgaged property and subsequently - of the property rights to the real estate.

Thus, the securities of the specialized secondary mortgage market institution will be attractive for various investors due to their apparent advantages and will ensure the creation of the wide financial basis for mortgage lending on a regular self-financing basis. As the standardized secondary market develops, the state participation in the financing (guaranteeing) of the activity of the Mortgage Agency will be decreased.

In order to create well developed mortgage market, it is necessary to perform a considerable amount of work on creating the system of relationship between the Mortgage Agency and the banks, forming the issuance mechanism for the mortgage covered securities, ensuring their safety and yield, and providing legislative framework for the functioning of the secondary mortgage markets.

6.3. *Principal measures on the creation of the housing mortgage lending system.*

1. Creation of the regulatory and legal basis providing the environment for the development of the mortgage lending.

Creation of the favorable legal environment for banking activity is a necessary condition for the development of the long-term mortgage lending.

The Decree of the President of Ukraine "On Measures Related to Developing Mortgage (Hypothecation) Market in Ukraine", of August 8, 2002, provides conceptual definition of the program of legislative activities.

The first part of the Decree defines the priorities in the organization of the mortgage market in Ukraine:

- «the formation of legal-normative framework on hypothecation which will enable to effectively use the hypothec as additional source for attracting money to resolve socio-economic problems;
- creation of the system of guarantees and transparent environment for the mortgage/hypothec market participants, first of all through introducing the effective system of state registration of rights to immovable property, standardization of activity on mortgage market, establishing mechanisms for insuring mortgage loans;
- establishing types of mortgage securities, establishing the procedure for issuing them and their circulation, ensuring the proper control over their circulation»

The main laws that will regulate the development of the mortgage market in Ukraine in the near future are:

- new Civil Code;
- Mortgage Law
- The Law on Registration of Rights to Immovable Property.

Once again, when preparing these laws, it is necessary to pay attention to the following:

- the design of the new legislation is suffering primarily from the lack of mutual coordination: the draft of the new Civil Code and the draft laws on mortgage and registration do not fully correspond to each other and thus need to be reconciled;
- the draft of the new Civil Code, rather satisfactory in other respects, still needs further improvement with regard to the articles dealing with the mortgage lending system, e.g. with the issues of the order of satisfying the creditors' rights and the registration of rights to real estate;
- satisfactory draft law "On Mortgage" does not reflect the special features of the housing mortgage or land mortgage;
- definitions have to be provided for the conceptual issues regarding the registration of rights to real estate (what, where and how to register), as well as the institutional issues (who is the boss).

Further steps:

- Improvement of the tax legislation in such a way that it facilitates the development of the mortgage lending system;

- Further improvement of the Law "On Recovering Borrower's Solvency or Recognizing the Borrower as Bankrupt";
- Further improvement of the Law "On Execution Proceeding";
- Creation of proper regulatory and legal basis for the reliable functioning of the mortgage lending, first of all:
 - regulations of the National Bank;
 - instructions providing the system of registration of rights to immovable property;
- At a certain stage (when the issues of the organization of the primary mortgage market are resolved) the issue of the adoption of the Law "On Mortgage Securities" will arise.

The overall number of the regulatory and legal acts can be even greater than it is stated in the above Presidential Decree. For example, it is possible that it will be necessary to create model regulatory and legal acts of the local self-government bodies regarding the support of the mortgage lending system.

2. Development and introduction into the banking practice of the standard procedures for arranging and issuing mortgage loans to the population.

For the purpose of lowering the mortgage lending risks and ensuring the "transparency" of the utilized mortgage lending schemes, the following work has to be done:

- development of mortgage lending instruments corresponding to various economic conditions and ensuring the interdependence of the interests of the bank and the borrower;
 - development of the procedures for the analysis of the borrower's solvency and loan security, i.e. mortgage loan underwriting;
 - creation of the procedure for issuing mortgage loans;
 - development of the system of agreements for the issuance of mortgage loans;
 - creation of the system of servicing mortgage loans, including the development of appropriate software;
 - development of procedures for working with problem loans.
3. Forming the conditions for the development of the mortgage securities market:
 - theoretical and methodological examination of the options for the issuance of securities by the banks; comparative analysis of various options; substantiation of the most acceptable option;
 - development of proposals on introduction of changes into the current legislation and creation of new regulatory and legal acts necessary for the issue and circulation of mortgage securities;
 - development of instructions and provisions regulating the issue and circulation of mortgage securities;

- methodical and methodological analysis of the economic parameters of mortgage securities;
 - development of the mechanism ensuring the safety of mortgage securities and the system of guarantees;
 - preparation of the legislative acts describing the activities of specialized mortgage institutions (mortgage banks or mortgage companies – if such a decision is undertaken);
 - development of proposals on changing the legislation in regard of assigning to mortgage certificate the status of security that can circulate under a more simple scheme than the assignment of claim rights under loan agreements.
4. Creation of conditions providing access to the mortgage securities market to institutional investors with long-term resources:
- Substantiation of safety of the mortgage securities;
 - Permission for pension funds to buy mortgage securities (in case of their creation), development of appropriate regulations and instructions;
 - Development of measures on attracting foreign investors to the mortgage securities market.
5. Organization of specialized secondary mortgage market institution:
- Methodological and methodical analysis of the issues of organization of the specialized secondary mortgage market institution (Mortgage Agency);
 - Work with government authorities (Ministry of Finance, Ministry of Economy and others) regarding the forms of government participation in the creation of the Mortgage Agency and provision of state guarantees, etc.;
 - Development of the business plan for the Mortgage Agency;
 - Preparation of the constitutive documents of the Mortgage Agency;
 - Development of the mortgage lending standards, requirements to the banks' mortgage lending activity, criteria for selection of partner banks by the Mortgage Agency, documents defining the relationship of the banks with the Mortgage Agency;
 - Methodological, methodical and legislative analysis of the issues defining the types, conditions and economic parameters of securities covered by mortgage loans, including introduction of relevant changes into the legislation;
 - Development of the pricing policy and risk management policy for mortgage securities emission;
 - Practicing the mechanism of assigning the rights under mortgage loans and issuing securities covered by mortgage loan pool;
 - Organization and implementation of pilot project.
6. Forming the infrastructure of the mortgage market.

- Development of the insurance techniques for mortgage lending: personal insurance and real estate property insurance, including property rights insurance;
 - Examination of options and conditions of mortgage lending risk insurance;
 - Preparation of the system of agreements defining the mortgage insurance products;
 - Preparation of the unified appraisal policy for real estate which serves as security for mortgage loans;
 - Creation of the information system on the real estate transactions and real estate prices.
7. Forming the system of training banking specialists and other mortgage market participants, including the following issues:
- Main stages and elements of the mortgage lending process;
 - Legislative basis of mortgage lending;
 - Mortgage lending procedure;
 - Probability estimate of mortgage loan repayment;
 - Methods of financial calculation of mortgage loan payments;
 - Mortgage lending risk management;
 - Legal framework for mortgage lending process;
 - Foreign practice of mortgage lending;
 - Characteristics of the relationship between the various mortgage lending market participants;
 - Primary and secondary mortgage markets;
 - Characteristics of mortgage securities;
 - Risk management for the emission of securities covered by mortgage loans;
 - The role and functions of the specialized secondary mortgage market institution;
 - Servicing mortgage loans;
 - Mortgage pricing;
 - Organization of the mortgage lending insurance system;
 - Real estate appraisal techniques.

It is necessary to organize a comprehensive training course which should include all principal issues of housing mortgage lending, as well as certain advanced courses for specialists in different fields. In addition, specialized courses should be developed for appraisers, insurance specialists, realtors, and securities specialists.

7. Annexes

Annex 1

USAID Ukraine Enterprise Land Sales Project: Objectives and Results

The objective of the UKRels (Ukraine Enterprise Land Sales) project was to support land reform in Ukraine, which has been stated to be a priority of the Ukrainian Government.

The Enterprise Land Sales Project (October 1997 – December 2000) was a coordinated effort between the Government of Ukraine and the United States Agency for International Development implemented by The Recovery Group/Chemonics International. Its objectives were to provide assistance to local bodies of self-government and Ukrainian private enterprises in the privatization of non-agricultural land parcels and the development of commercial real estate markets.

UKRels established over 30 offices in 28 regions, plus a regional sub-office in Crimea.⁵⁴ All these offices were actively accomplishing enterprise land sales that resulted in significant income to local budgets.

The Project began in November 1997 and was originally scheduled to continue for 12 months. The project has been extended twice based upon the significant results of all the Ukrainian specialists and managers in the regions where UKRels has been working. It was completed in December 2000.

Experts on the Project worked directly with city and oblast officials and enterprise owners and managers. This cooperation aimed to accomplish the following objectives:

- Assist the municipalities in starting the process of privatizing land allocated to enterprises, and
- Develop an enabling legal and human skills environment for urban land markets in general.

At the local level UKRels was addressing this situation by furnishing:

- Legal consulting for local governments and companies about issues of land ownership and sales;
- Help to implement effective methods of land appraisal;
- Help to develop and implement effective procedures for land sales;
- Assistance to enterprises to navigate the land privatization process; and
- Consultation with individual enterprises on land values.

⁵⁴ Some information in this chapter was obtained from Lou Faoro and Justin T. Holl Jr, the two directors of the UKRels project.

Analyses of the UKRels achievements shows that they have been significant for the Ukrainian land market. Fundamental business decision for any enterprise operating in a market environment is whether to lease or rent the land under the enterprise or purchase the land. When this project began, local authorities believed there would be little interest in land purchase, since so many enterprises had managed to acquire their land for permanent use.

However, having permanent use rights to land did not deter enterprises from buying the land. Weak government commitment to and assistance in land privatization was a far more serious problem.

In four years, approximately 6,000 land transactions have taken place, generating over \$30 million for local budgets. Over 4,000 of these transactions include State Act issuance. There has been at least one land sale in 85% of all rayons in Ukraine. This broad and dispersed land acquisition has spawned a demand for more land. Each land purchase generated by the project created demand for purchase of an additional 0.4 hectares of land. A market infrastructure is firmly in place. Limits to the potential of land parcel purchases in Ukraine have been far exceeded.

Recent reviews show that 57% of the firms which have purchased land increased their profits. Of these, 31% increased profits by 10% or more. Nearly half of those reporting increased profits attribute this directly to land acquisition. 54% of all firms increased sales of their primary products or services, of these 26% increased sales by more than 10%.⁵⁵

50% of these firms increased production of their main product or service, 41% of all firms that produce secondary products or services increased the output of those secondary products or services.

56% of these firms have hired additional staff since land acquisition. The total of these new employees constitute 18% of the firms' employment. In addition, 67% of all firms increased the salaries they pay to employees

Advocates of land privatization held that the firms acquiring land would seek the best uses for it, and land acquisition would result in economic benefit to the firm. This implied internal restructuring by management of the firm. Such restructuring has taken place: after land purchase, 53% of all enterprises began a new product line or service.

In the result of such restructuring 42% of firms decided to purchase additional land within the next year. Of these the largest percentage (36.1%) will purchase land for which the firm holds no lease or permanent use rights; (Note that 27% of these firms already acquired more land after the initial purchase.) Secondary land sales are no longer unusual. A land market is forming and will grow more quickly in sophistication and vitality once land financing becomes available.

Enterprise plans for acquisition of more land indicate that a strong and dynamic land market is beginning to form. The enterprises providing this data now have experience

⁵⁵ Land Purchase Impact Report, Chemonics ULTI Project, Kiev, Ukraine, June 2002.

with using land as a business asset, and the experience has proved positive. These enterprises have directly invested in land, learned its value, and want to buy more of it. This implies growing wealth of Ukrainian firms (at least those in the survey group), since there is still no land financing sources.

The opportunity to acquire land still attracts successful enterprises. Enterprises that make this strategic decision tend to be already successful and generally use the acquired land not to achieve but to increase success. These firms demonstrate a certain business vision and acumen that seems to be associated with economic success and is not present in enterprises that decide not to purchase land.

It has been proved that enterprises that acquired land perform better economically than those that did not. Of the approximately 6,000 enterprises that have opted to acquire land through our programs, 70% have had land acquisition as a business goal. They saw the USAID land reform projects as an opportunity to acquire land. The remaining 30% of land buyers did not have land purchase in their plans and received the idea from our land reform projects. These two groups differ in a variety of key economic performance indicators. Both groups perform better economically than enterprises that choose not to acquire land.

Absence of commercial land financing is the main technical obstacle retarding the emergence of a dynamic, expanding land market. Very few enterprises which have purchased land have received loans secured only by land. The startling fact that those enterprises which have got bank loans, have had to pledge 100% of their assets in order to receive any type of commercial loan clearly demonstrates the marginal utility of financial markets, especially as applies to land transactions.

However, most land-purchasing enterprises say that attracting outside investment was a reason for acquiring land. But Ukraine yet is not generally attractive to investors and is lagging other countries in this area. Small enterprises that acquire land parcels do not do so in order to attract investors. Larger enterprises often do acquire land to attract investors.

Concern of some Ukrainian officials and a source of outright opposition by many local legislators was the notion that privatization of land was not desirable, since it would lead to speculation. However, it has become obvious that enterprises use purchased land parcels for primary business, not for speculation. Less than 8% of the surveyed enterprises re-sold or leased part of the land they acquired.

Once purchased by the enterprise, land become economically more productive. Transferring the land into direct ownership of the enterprise was an important step toward identifying the highest and best economic use of the land parcel, as it is confirmed now by participants of the project.

Purchased land has appreciated and serves as a hedge against inflation. Confirmation of this indicates that the forming land market in Ukraine is beginning to be driven by some of the same forces found in mature markets. Inflation, increasing demand, and future expectation are three of these. Likely they already are present to a degree in the nascent Ukrainian land market.



Land purchase has had short-term as well as long-term benefits. Recent surveys⁵⁶ indicate that purchase rather than lease of land still is, under normal circumstances in Ukraine, the sounder one. In addition, there are other aspects of land acquisition such as benefits accruing from use of the land, increase in land value, relief from government involvement, inheritance rights, commercial borrowing implications, investor attractiveness, increased flexibility, and the like.

⁵⁶ Land Purchase Impact Report, Chemonics ULTI Project, Kiev, Ukraine, June 2002.



Annex 2

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